UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF ADMINISTRATIVE LAW JUDGES

In the Matter of: BENJAMIN B. WEITZ COMMUNITY HOUSING AND RESEARCH CORPORATION Respondents	HUDALJ 94-0009-DB Decided: January 9, 1995

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For the Government

Before: ALAN W. HEIFETZ
Chief Administrative Law Judge

INITIAL DETERMINATION

Statement of the Case

This proceeding arose pursuant to 24 C.F.R. §§ 24.100, *et seq*. as a result of an action taken by Jeanne K. Engel, signing for Nicolas P. Retsinas, Assistant Secretary for Housing-Federal Housing Commissioner of the U.S. Department of Housing and Urban Development ("HUD," "the Department" or "the Government"), on October 22, 1993, proposing to debar Benjamin B. Weitz and his named affiliate, Community Housing and Research Corporation ("CHRC")[1] for a period of three years. Mr. Weitz and CHRC were also suspended pending the outcome of any hearing on the proposed debarment.

[1]Mr. Weitz and CHRC are collectively referred to as "Respondents."

The action taken by HUD was based upon allegations of "irregularities" in Mr. Weitz' actions as former president of Community Management Corporation of Rockville, Maryland ("CMC"), as an owner of CHRC, and as general partner of six multifamily housing projects with mortgages endorsed for insurance under the National Housing Act.[2] If debarred, Respondents would be prohibited from participating in covered transactions as either participants or principals at HUD and throughout the Executive Branch of the Federal government and from participating in procurement contracts with HUD.

Respondents requested a hearing on the suspension and proposed debarment by letter dated November 19, 1993. The suspension was subsequently terminated,[3] and a hearing on the proposed debarment was held in Washington, DC on June 6-15, 1994. The parties timely filed their post-hearing briefs on July 22, 1994, and their reply briefs on July 29, 1994. There being no outstanding pleading which requires issuance of a ruling independent of this Initial Determination,[4] this matter is ripe for decision.

Summary of Major Findings and Conclusions

This proceeding has its genesis in a 1991 Audit Report of the Regional Inspector General for Audit, Region III. Although the Audit Report covered the period from October 1986 to December 1990, the thrust of the proposed debarment is aimed at events occurring almost 20 years ago. Excessive discovery requests and numerous procedural motions filed by the Government have not only unduly protracted this litigation, they have made the ultimate resolution of this case unnecessarily complex.

The Regional Inspector General's 1991 Report was an "audit report" in name only. It verified nothing, did not describe the files and documents that were actually examined with any particularity, contained only summary conclusions without any detailed subsidiary findings, and grossly overstated the percentage of Respondents' distributions from multifamily projects that could possibly be subject to question. Although the Audit Report might have been a useful investigatory tool with which to

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[2]The October 22, 1993, letter notifying Respondents of the suspension and proposed debarment incorrectly referenced only Section 236 of the National Housing Act. As discussed *infra*, the relevant sections are 236 and 221(d)(4).

[3]The basis for and circumstances surrounding termination of the suspension are detailed below under the heading "Background."

[4]Respondents' Motion to Dismiss Amended Complaint filed on April 15, 1994, and the Government's Motion to Strike filed on August 1, 1994, were not ruled upon prior to issuance of this decision. They are addressed and decided below.

begin a dialogue with the examinee, the Regional Office of Housing instead treated assertions in the report as gospel truths leading to inviolable conclusions.

When Mr. Weitz questioned the underlying findings and assumptions in the Audit Report, he was repeatedly rebuffed, even though he provided voluminous documents to program officials, including restated computations of surplus cash[5] for the projects. He was told that the audit could be resolved only if he would pay the $1.2 million he was alleged to owe the Government. When he had the temerity to refuse payment and continue to dispute the audit conclusions, he was issued a Limited Denial of Participation ("LDP") in order, in the words of a HUD official, "to accelerate" audit resolution.

Mr. Weitz appealed the imposition of the LDP. That appeal, heard by Administrative Judge Greszko of the HUD Board of Contract Appeals, spawned a discovery battle during which Mr. Weitz unsuccessfully sought documents from the Government. Meanwhile, a newly hired Regional Comptroller propagated a host of new questions about the restated computations of surplus cash, expanding what had begun as an audit covering the years 1986-1990 into a global investigation covering virtually the entire history of the projects dating back to 1975. To resolve this newly defined audit, the Government put the burden on Mr. Weitz to produce documents substantiating accounting procedures and bookkeeping entries from 1975 forward, while at the same time refusing to produce documents in the Government's possession that purportedly supported the earlier audit findings and the LDP.

The new Regional Comptroller recommended that Mr. Weitz be required to repay $1.2 million, without reviewing the certified financial statements that Mr. Weitz had filed regularly with HUD since the projects began. The Regional Comptroller instead based his recommendation on Mr. Weitz' restated computations of surplus cash that did not, and indeed could not, claim certifiable accuracy.[6] Out of $2.8 million recorded in the

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[5]Briefly, surplus cash is any cash remaining after current mortgage payments, deposits to a reserve fund, and payments of certain other obligations. Under certain circumstances, money may be paid only out of surplus cash. The restatements of surplus cash were compiled by Mr. Weitz' current accountant in an effort to respond to questions raised in the Audit Report.

[6] Because some underlying workpapers were not kept in perpetuity, and because the restatements were never intended to reaudit past financial statements, the restatements themselves could not be certified as accurate. Disclaimers transmitting the restatements to HUD expressly conveyed these

projects' books as advances plus interest, the Regional Comptroller recommended that Mr. Weitz be credited with approximately $1.6 million as the amount he was entitled to withdraw. While recognizing that Mr. Weitz had not withdrawn that $1.6 million, the Comptroller nevertheless concluded that Mr. Weitz should repay $1.2 million to the projects.

The discovery battle in the LDP proceeding came to a head on October 15, 1993, when Judge Greszko ordered the Government to respond by noon on October 22 to Mr. Weitz' motion to dismiss the LDP. Rather than respond to the motion, Government attorneys met in headquarters with an official in the Office of Housing to whom they recommended the suspension and debarment of Mr. Weitz. The Office of Housing official was unaware of Judge Greszko's order requiring the Government to respond to the motion to dismiss the LDP, and Regional officials were unaware that Government attorneys were proposing the suspension and debarment of Mr. Weitz to officials in headquarters. Government attorneys were the sole source of the information that the program official relied upon to issue the letter suspending and proposing to debar Respondent. Program staff in headquarters had no personal knowledge of any of the facts and took no independent action to verify the accuracy of those facts. The letter suspending and proposing to debar Mr. Weitz was issued October 22, the due date for the Government's response to the motion to dismiss, and the same day Government attorneys filed a motion with Judge Greszko seeking to dismiss the LDP on the asserted ground that it had been superseded by the suspension and proposed debarment.

Judge Greszko certified to the Secretary the question whether the suspension and proposed debarment superseded the LDP. Judge Greszko found substantial evidence to support Mr. Weitz' allegation that he was suspended as "a tactic to avoid a hearing on charges that Government counsel was intentionally failing to comply with the Board's discovery orders." He concluded that the "timing of the suspension at issue is unfortunate, at best, and evidence of possible abuse of process, at worst. . . ."

The suspension and proposed debarment were assigned to me for hearing. The Government filed its Complaint on December 16, 1993. I ordered the Government to address the issue of immediate need for suspension in an Amended Complaint. On January 31, 1994, I granted Mr. Weitz' motion to terminate his suspension, finding not a word in the Government's amended complaint that alleged any immediate need to impose a suspension during litigation of the debarment proposal.

On May 2, 1994, I issued an order addressing, *inter alia*, Mr. Weitz' motion to dismiss the amended complaint because it was filed as a tactical maneuver to avoid the LDP and not in good faith. Citing the apparent lack of input by HUD program officials into the recommendation to suspend and debar Mr. Weitz, and the fact that the

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limitations.

Government had been unable to justify the suspension, I concluded that "the drawing of an inference of Government misconduct from such factors at [that] stage of the proceeding...would be premature, since the Government yet had an opportunity to present its case in chief."

Although the Government has now had its opportunity to present its case in chief, the record still contains no direct evidence demonstrating the Government's motivation in bringing the suspension and debarment actions. That motive lies hidden behind a claim of attorney-client privilege. However, having previously concluded that absolutely no evidence was presented to justify the suspension action, and now concluding that the Government has failed by a wide margin to show cause for debarment, I find a strong inference in this record that the suspension of Mr. Weitz was imposed for improper reasons in order to perpetuate the effect of the LDP without having to adjudicate its merits. Nevertheless, I decline to grant Mr. Weitz' motion to dismiss because I am unable, on this record, to determine with certainty what was in the hearts and minds of those who made the decision to institute the actions that gave rise to this proceeding. I leave that determination to the Assistant Secretary for Housing-Federal Housing Commissioner and to the General Counsel. My determination that good cause does not exist to debar Respondent rests on an analysis of the merits of the case.

Count I of the Complaint alleges that Mr. Weitz made or directed to be made unauthorized "distributions"[7] from the operating accounts of the Projects in the amount of almost $1.2 million for "non-operating advances." The pertinent Regulatory Agreements allowed the Projects to repay advances for reasonable expenses incident to the operation and maintenance of the Projects, provided the Projects were not in financial jeopardy. Such repayments were not, at that time, considered "distributions" within the meaning of the Regulatory Agreements. All of the alleged non-operating advances occurred prior to the period covered by the 1991 Audit Report. Eighty percent of them concerned the years 1975-1979.

The Government's case in Count I rests on evidence prepared and submitted by Regional Comptroller Ward. I find that evidence unreliable, untrustworthy, and incredible. Mr. Ward prepared his evidence relying on restatements of surplus cash and restated balance sheets prepared by Mr. Weitz' current accountant. However, those restatements did not and could not guarantee that the figures contained therein fully and accurately represented the financial condition of the projects at any time during their history. The restatements were prepared only in response to an issue raised in the 1991 Audit Report. Indeed, the Government itself undermined the credibility of Mr. Ward's evidence by attacking the accuracy of the restatements during cross-examination. Mr. Ward relied on this unreliable material rather than review original

[7] In brief, a "distribution" is a withdrawal of cash from a project, excluding payments for reasonable operating expenses. Authorized distributions are limited in amount and may not be made in certain circumstances.

source documents, namely, the projects' original certified financial statements which were regularly filed shortly after preparation and which had never been questioned by HUD as to their accuracy or probity. Furthermore, Mr. Ward failed to consult with, or review the workpapers of, the original accountants who prepared the certified annual financial statements. He also failed to comprehend that entries made in ledgers and year-end financial statements are subject to adjustment if independent public accountants later

determine that economic reality, which could not have been known with certainty during the actual accounting period, requires that an entry be reclassified.[8]

Although the Government retained a nationally known accounting firm and identified representatives of the firm as prospective witnesses, those witnesses were never called to testify, leaving Mr. Ward's evidence standing alone and uncorroborated. Unable to substantiate the findings in his report, the Government has attempted to shift the burden of proof to Mr. Weitz, calling upon him to prove that the conclusions in Mr. Ward's report are incorrect.

Whatever credibility Mr. Ward otherwise might have enjoyed disappeared when he alleged that he was told by one of Mr. Weitz' former accountants that their firm refused to continue to do business with Mr. Weitz because members of the firm "weren't willing to do the kinds of things anymore that he wanted them to do." The allegation was flatly and credibly denied by three members of the firm, including the alleged maker of the statement, in testimony untainted by any financial interest in the outcome of this proceeding. The Government attorney present when the statement was allegedly made did not offer to take the stand to corroborate Mr. Ward's accusation.

Notwithstanding the grievous infirmities of the Ward Report, on the strength of that report the Government not only has threatened to initiate disciplinary proceedings against Mr. Weitz' accountants before their professional organizations, but has also accused Mr. Weitz and his accountants of a massive conspiracy to create "bogus loans" and evade taxes. That charge is casual calumny. There is no evidence of a conspiracy of any sort in this record. Because the projects incurred operating losses, particularly in the start-up years, the general partners, consistent with their obligations under the applicable partnership agreements, advanced, that is, "loaned," operating funds to the projects. These advances were properly reflected on the certified annual financial statements of the projects. They were not "bogus." Furthermore, no "project funds," as that term is employed by HUD, were used to repay non-operating advances made by the general partners. Finally, there is no evidence that any accountant violated a code of professional responsibility, and the record does not even suggest, let alone prove, a motive to explain why three different accounting entities would engage in an unlawful conspiracy or otherwise put their reputations at risk. The Government has wildly hurled accusations of unlawful conduct against Mr. Weitz and his accountants with no basis in fact.

Count II alleges the misuse of an operating loss loan that the Pemberton Manor partnership obtained from HUD in 1978. The loan, its use, and the modification of the

[8] A "reclassification" is a form of an adjusting journal entry, usually made to transfer amounts from one asset account to another, or from one liability account to another. For example, an account that had been maintained on an accrual basis might have to be reclassified when a financial statement is prepared on a cash basis.

Pemberton Manor mortgage had never been questioned by any official of HUD or the Federal National Mortgage Association ("FNMA"), until a July 1993 meeting that Mr. Ward had with Mr. Weitz and his accountant. In his opening statement, Government counsel charged that the loan was "obtained by false pretenses or not used for its intended purpose," that it was used to repay development fees,[9] and that it violated a regulatory provision prohibiting distributions by the projects from borrowed funds.

The National Housing Act authorizes insurance of a supplemental loan to cover the loss experienced by a mortgagor of a multifamily project during the first two years of the project's operation. A HUD Handbook refers to this "two year operating loss" and note that "recoupment" is limited to the amount certain disbursements and expenses for maintenance and operations exceed income. The plain meaning of "recoupment" is reimbursement of funds expended.

The audited financial statements filed with HUD show that during the first 16 months of operation that began in October 1975, the Pemberton Manor project incurred losses from operations of $329,638. In August 1978, after making its own calculations, HUD issued a commitment to insure an operating loss loan in the amount of $292,500. Notwithstanding that this commitment approximated the amount finally requested by Mr. Weitz, the Government alleges, on the basis of fragmentary evidence, that he induced HUD to insure a loan that would be used in part to fund construction deficiencies at the project -- that is, that HUD insured an "operating loss loan" used to fund something other than operating losses.

Although before the hearing the Government listed potential witnesses from the Housing Management Division of HUD which approved the loan, FNMA which approved a mortgage modification, and CMC which applied for the modification, the only witness actually called to testify on this issue was Mr. Ward. He questioned the Operating Loss Loan because some of the documents pertaining to the original request for a larger loan referred to a request to escrow a portion of the funds to correct construction deficiencies. Other documents concerning a related mortgage modification referred to use of the loan proceeds to make repairs. However, the trail of documents referring to construction deficiencies ended in February 1978, some six months before the final commitment was issued. The final commitment, in the amount of $292,500, expressly stated that it constituted "the entire agreement" between the parties. It contained 15 conditions, none of which addressed construction deficiencies. The mortgagee commitment made no reference to the repair of construction defects and incorporated

[9]Development fees are paid for activity occurring prior to the time that a multifamily project actually becomes operational. They are to be paid out of capital contributions to the partnerships and not out of project funds.

the same conditions as FHA. Accordingly, there is no evidence that any official was induced to take any action with regard to the loan on the basis of a commitment to use the proceeds for any reason other than to reimburse operating losses.

Mr. Ward also took issue with two reclassifications in Pemberton Manor ledgers which he believes resulted in inflated operating losses that were used to justify the request for the loan. Respondents presented evidence that the reclassifications were proper allocations between operating advances and development fees. The validity of Mr. Ward's concern cannot be determined because there was no testimony from those who made the reclassifications some 17 years ago, and not all the workpapers have been found. Accordingly, the Government has failed to prove that the reclassifications were improper.

Finally, the Government alleges that use of the loan proceeds to reimburse CHRC for operating advances constituted a distribution by the project from borrowed funds. However, the advances were made by CHRC, they covered the operating losses incurred by the projects, and the loan was applied for by CHRC. The proceeds were issued to the limited partnership, which in turn endorsed the checks over to CHRC. Accordingly, there is no evidence that any project funds, rather than partnership funds, were distributed.

Count III alleges that Mr. Weitz improperly "paid himself a 'note payable' in the amount of $212,033 from project funds of the Essex House project."[10] This is another allegation that arose from Mr. Ward's analysis of financial statements outside the ambit of the Regional Inspector General's 1991 Audit Report.

The note itself evidences a non-interest bearing debt incurred in 1975 that was owed to CHRC for development fees by the limited partnership that owned Essex House. It had been paid down in 1983 to $212,033. Having found himself engaged in what has been described by one HUD loan analyst as a long "paper war" over rent increases to help fund roof repairs at Essex House (Counts IV and V, *infra*), Mr. Weitz ordered an employee of the projects' management company to close certain reserve accounts and to pay off outstanding operating advances. The employee was not called to testify at the hearing, and there is no evidence upon which I could conclude that the employee was directed to consider this particular obligation an operating advance and to pay it off. I credit the testimony of both Mr. Weitz and his accountant that the employee erroneously read a financial statement and concluded that the $212,033 represented the balance owed on an operating loan. As a result, in April 1990, the employee paid that amount plus interest out of an Essex House project account into an account of CHRC. The facts surrounding the payment of the note cannot be stated more definitively, yet the Government, on brief, complains that Mr. Weitz "has yet to

[10]The note was actually paid to CHRC. Mr. Weitz held 26% of its shares.

fully explain what has happened to the $212,033." However, the burden of proof in this case is not on Respondents.

In the summer of 1991, Mr. Weitz' accountant discovered that the obligation had been recorded as a note payable, rather than as a development fee payable. Because a development fee may not be paid out of surplus cash, and because the development fee is an obligation of the limited partnership, not of the project, Mr. Weitz and his accountant determined a way to rectify the error. A portion of funds that had been invested by CHRC in a financial asset were assigned to the limited partnership. That portion corresponded to the amount due back from CHRC to the limited partnership, plus interest. When the funds became available, that amount was paid over to the limited partnership. A corresponding credit to the project was made by reducing the amount of limited distributions payable to the limited partnership by the project.

Count IV alleges that Respondents failed to properly maintain the roof systems at two of the projects, Essex House and Pemberton Manor. "Maintenance" of the roofs did not become an issue until HUD and Mr. Weitz reached an impasse over who would finance and ultimately pay for replacement of the roofs which, as early as 1977, were known both by HUD and Mr. Weitz to have been defectively constructed. The denouement occurred in early 1990 when Mr. Weitz closed voluntary "rainy day" accounts[11] in response to HUD's rejection of applications for rent increases. Those increases would have covered debt service on loans for the replacement of the roofs.

There was absolutely no evidence of any health or safety concerns, or of any tenant complaints, that related to the maintenance of the roofs at either project. There is ample evidence to demonstrate that, both before and after the liquidation of the "rainy day" accounts, Mr. Weitz has continuously taken interim maintenance measures to assure that the roofs have performed adequately, pending implementation of plans to fully replace the roofs at each project. The quality and extent of that maintenance, given the acknowledged need for a permanent solution to remedy construction defects, has not been shown to have been improper or unreasonable. A plan to replace the roof system at Essex House has been approved by HUD and the specifications have been sent out for bids. Plans for Pemberton Manor will not be cleared by the HUD Baltimore Office until the LDP and debarment proceedings are resolved.

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[11]The propriety of liquidating the "rainy day" accounts and the use to which the funds were put - the repayment of operating advances - were triggers for the Regional Inspector General for Audit ("RIGA") audit. The "rainy day" accounts were funded by surplus cash which otherwise could have been used to repay operating advances by the limited partnerships, and were established to build up extra reserve funds to cover, *inter alia*, repairs and replacements that would not be covered by the ordinary reserve fund. Mr. Weitz believed that establishment of these accounts was necessary because he could not induce the general partners to make further infusions of cash.

Count V alleges that Respondents improperly distributed $223,965 in Essex House project funds while high urgency maintenance items[12] were outstanding.[13] Paragraph 6 of the regulatory agreement prohibits a distribution if the project is not in "compliance with all outstanding *notices* of requirements for proper maintenance of the project." (Emphasis added.) The Government argues that Respondents received the requisite notice upon receipt of a HUD physical inspection report in June 1989 that was issued in connection with Mr. Weitz' request for a rent increase at Essex House. Respondents argue that the inspection report did not suffice to invoke the Regulatory Agreement's prohibition against distributions for two reasons. First, they did not receive written notice of maintenance deficiencies sent by registered or certified mail and signed by the Federal Housing Commissioner as required by the Regulatory Agreement. Second, they did not receive any specific notice, directly or through any established policy or practice, that outstanding high urgency deficiencies noted on an inspection report precluded distributions until those deficiencies are cleared by HUD.

The Regulatory Agreement is ambiguous as to the form of notice required to preclude a distribution. Paragraph 11, the only other provision referring to "notice" in the Regulatory Agreement, refers to a "written notice. . .by registered or certified mail" that the Federal Housing Commissioner "may" give to an owner if any provision in the Regulatory Agreement has been violated. If the violation is not corrected, the Commissioner "may" then declare a default. Paragraphs 6 and 11 do not cross-reference each other. Moreover, by their express terms, they address different scenarios: Paragraph 6 pertains to notice of outstanding maintenance requirements and Paragraph 11 pertains to notice of Regulatory Agreement violations. Thus, while it is clear that "notice" for the purpose of Paragraph 11 must be in writing and sent by registered or certified mail, the same cannot be said of Paragraph 6.

The Regulatory Agreement's ambiguity is not clarified by any agency policy or practice. The Government cites no HUD handbook, bulletin, issuance, or training curriculum stating that distributions are prohibited upon receipt of an inspection report noting "high urgency" maintenance deficiencies. Three HUD witnesses testified to the effect that there is no uniform practice within the agency as to how notice is given, what constitutes notice, or whether notice in an inspection report "automatically" prohibits distributions. Finally, there is no evidence that loan servicers uniformly require repayment of distributions if they discover inspection reports noting high urgency deficiencies while reviewing project financial statements.

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[12]The only "maintenance" deficiency of any real concern to HUD was the roof. The Office of Housing recommended that the entire audit finding upon which this count is based be closed. However, the RIGA agreed to close the finding only as soon as the roof had been repaired. Despite the cited deficiencies, the inspection report found the property to be in "satisfactory" condition, that it was "very well maintained", and that the maintenance policies and procedures were "superior."

[13]Of this amount, $212,033 is the note that was erroneously paid. *See* Count III, *infra*.

In the absence of: 1) any formal notice in writing by the Commissioner; 2) any other specific notice that a distribution would be improper in light of the inspection report; or 3) any published rule, regulation, or practice that prohibits distributions in light of deficiencies noted in an inspection report, the Government has failed to show that Respondents have violated the Essex House regulatory agreement and that cause for debarment exists under Count V.

In summary, the evidence on all counts fails to demonstrate cause for Respondents' debarment, and therefore, that they are not presently responsible to continue to do business with the Government. This is not a case involving moral turpitude, nor is it one of a neglectful property owner. It is about a tough-minded businessman who dared challenge the federal Government's view of how best to operate and maintain multi-family housing projects. When Mr. Weitz disputed the conclusory findings of the audit and refused to pay what he claimed was not owed, a limited denial of participation -- and later, a suspension and this proposed debarment -- was held over his head like a sword of Damocles, a "tool" to exact compliance, not to encourage conciliation. In the main, this proceeding has turned into a dispute over ledger entries and financial activities that occurred up to twenty years ago, long after original source documents and workpapers are usually kept. It is a case based on an erroneous analytic foundation and fragmentary facts.

When the debarment and suspension action was initiated in Washington, D.C., the officials responsible for its initiation were unaware that Government counsel had been ordered to respond to a motion alleging "intentional, flagrant, and continuous" violations of a discovery order issued in the LDP proceeding. At the same time, officials in the Regional Office, who had been attempting to resolve the audit findings until Government counsel requested cessation of those efforts, did not know that officials at headquarters were considering a suspension and proposed debarment. Given the substantive weakness of the case against Respondents, the circumscribed knowledge of that weakness afforded the debarring officials, and the time, effort, and money expended by all parties to this litigation, it is at least questionable whether the government has exercised appropriate prosecutorial discretion in this case.

Findings of Fact

I. Background

1. Mr. Weitz is the managing general partner of the limited partnerships that own the following six multifamily housing projects having mortgages endorsed for insurance by the Federal Housing Administration ("FHA"): Essex House Apartments, Alexandria Virginia; Pemberton Manor Apartments, Salisbury, Maryland; Valley Vista Apartments, Woodstock, Virginia; Jefferson House Apartments, Lynchburg, Virginia; Royal Arms Apartments, Front Royal, Virginia; and John S. Perry House, Woodstock, Virginia ("the Projects"). The mortgages for all the projects excepting John S. Perry House were endorsed for insurance under Section 236 of the National Housing Act. The mortgage

for John S. Perry House was endorsed under Section 221(d)(4) of the National Housing Act, 12 U.S.C. §§ 1715-z1, 1715l(d)(4), respectively. Amended Complaint, ¶¶ 3, 4; Answer,[14] ¶¶ 3, 4; Tr. 42.[15]

2. Mr. Weitz formed CHRC in 1971 to undertake the development of Section 236 housing. Since its development activities ceased in 1975 or 1976, CHRC has performed "asset management" -- oversight and participation in the functions that CMC performs for the Projects. CHRC has also been a creditor of the Projects, excepting John S. Perry House, having lent funds to the limited partnerships. The shareholders of CHRC are the general partners of the limited partnerships that own the Projects for which CHRC has been a creditor. Another company, Housing Resource Corporation, ("HRC") owned by Mr. Weitz and his wife, has been a creditor of John S. Perry House. Tr. 56-61, 70.

3. CMC is the management agent for the Projects. Mr. Weitz was the president of CMC from its inception in April 1972 until 1977, from 1982 until 1986, and from 1987 until October 15, 1991. Mr. Weitz became the sole shareholder of CMC in 1982, and he sold the company to its current employees on October 15, 1991. Tr. 49-51, 1621.

4. The Projects are "limited distribution" projects, subject to HUD regulations governing distribution of income, rents, charges, rate of return, and methods of operation. 24 C.F.R. §§ 236.10(c); 236.50; 221.531(b); 221.532; Amended Complaint, ¶¶ 10-13; Answer, ¶¶ 10-13; Tr. 462-63.

5. Each of the limited partnerships which own the Projects has a Regulatory Agreement with HUD. The Regulatory Agreements were signed by Mr. Weitz in his capacity as managing general partner. The Regulatory Agreements were in effect at all relevant times, and will not expire until the HUD-insured mortgages are paid in full. AR-4A through AR-4F; Tr. 42-43, 470, 479, 964.

6. Each of the limited partnerships has a Partnership Agreement. PA-PM; PA-RA; PA-JH; PA-VV; PA-PH; PA-EH.

7. The Richmond, Virginia, HUD field office had jurisdiction over Valley Vista, Royal Arms, Jefferson House and John S. Perry House. The Washington, D.C., HUD

[14]Citation to "Answer" includes Respondents' Answer to the Government's Complaint and their Answer to the Government's Amended Complaint.

[15]"Tr." is the citation to the transcript of the hearing held on June 6-15, 1994.

field office had jurisdiction over Essex House. The Baltimore HUD field office had jurisdiction over Pemberton Manor. Tr. 365-68, 722-23, 727, 799-800, 806, 864, 871.

8. On April 29, 1991, Edward F. Momorella, the Regional Inspector General for Audit, Region III of HUD ("RIGA") issued an Audit Report of CMC, Audit 91-PH-214-1009, to Linda Z. Marston, Acting Regional Administrator, Region III. The audit was "[b]ased upon a request from the Richmond Office,"[16] and concerned the Projects and Leesburg Manor Apartments, Leesburg, Virginia. The audit was conducted between August 1990 and January 1991 and covered the period of October 1, 1986, to December 31, 1990.[17] AR-1 at i, 1. The findings of the RIGA as summarized in the Audit Report were that CMC and Mr. Weitz:

> - Failed to repair two projects as instructed by the Washington and Baltimore Offices, and, contrary to Regulatory Agreement provisions, made ineligible distributions of $506,809.
>
> - Should improve internal controls over project operations. Deficiencies were evident in surplus cash and excess income computations, accounts receivable and payable, cash accounts, and balance sheet carry forward balances. Unsupported distributions totalled $1,111,722, and excess income of at least $32,114 computed by the Baltimore Office has not been remitted.
> - Charged $24,163 ineligible and $21,557 unsupported Agent and Owners costs to the projects.

[16]The primary motivation for the request concerned the closing of voluntarily established repair reserve accounts, and a question whether certain fees had been paid out of surplus cash or allowable distributions. Tr. 377.

[17]In January 1991, the RIGA held an audit exit conference with representatives of CMC. At that meeting, Mr. Weitz presented two boxes of information in support of CMC's response to the proposed findings of the audit. Irving I. Guss, the Assistant RIGA, advised Mr. Weitz that the conference was not the time to engage in a "re-audit." The RIGA staff did not review the entire contents of the boxes, but from selected documents on particularized issues, determined after a half-hour to 45 minutes of review that no new information had been submitted which would resolve the audit findings. Accordingly, the RIGA determined to issue the Audit Report. Tr. 1535-38, 1632-37.

> - Received $22,424 in excess utility payments from tenants when HUD was providing electric utility allowances through Housing Assistance Payments.
>
> - Received $11,316 in excessive management fees for several projects.

Id. at iii. The RIGA further stated that "[t]he deficiencies were generally the result of the Agent/Owner's noncompliance with agreements, regulations and requirements, as well as inadequately maintained books and records." *Id*. The RIGA recommended that CMC and Mr. Weitz "reimburse the projects for the ineligible amounts cited in the findings, and any unsupported costs not documented," "implement written procedures which follow HUD requirements for project operations," and "reimburse tenants for excessive utility costs paid." *Id*. at iv.

9. Although the Audit Report stated that "we reviewed pertinent records for seven HUD projects," and asserted that "its scope was limited by [CMC's] incomplete records," it did not specify which documents had actually been reviewed, and the attempts, if any, that had been made to obtain additional documentation from HUD or other sources.[18] *Id*. at 2. Of the $1,111,722 in distributions that the Audit Report concluded were unsupported,[19] $470,673 was attributed to Leesburg Manor, a profit-motivated enterprise not subject to the distribution limitations alleged to have been violated in the Audit Report. *Id*. at 10; Tr. 1231.

10. After the Audit Report was issued, the three field offices with jurisdiction over

[18]The Audit Report was not based on a review of the financial statements for the projects going back to inception; rather, the auditors reviewed only those covering 1986 through 1990. The auditors did not seek access to the complete set of underlying workpapers, nor did they consult the accounting firm which had prepared the statements. Tr. 1463-65, 1488, 1493, 1513-1516, 1529-30.

[19]No detailed explanation was set forth for the total figure, the figure was not broken down into its component parts, and the source of the numbers used in calculating surplus cash was not provided. Tr. 1211-12.

the Projects engaged in audit resolution.[20] Tr. 300-01, 505-06, 569-70, 584.

[20]Once the Audit Report was issued, responsibility for audit resolution and closure effectively rested with staff of the Office of Housing, although resolution and closure required RIGA concurrence. Tr. 1448, 1460, 1466-67.

11. In October 1991, Kathleen Flaherty, Mr. Weitz' current independent accountant, gave Mr. Weitz Lotus spread sheets she had prepared setting forth separate restated surplus cash accounts and restated balance sheets for the Projects and the partnerships. The spreadsheets were prepared with the intent that they be used, in conjunction with the annual financial statements and other available information, as a tool in resolving the Audit Report finding number 2.[21] They were not intended to be relied upon as audits. Mr. Weitz submitted the spread sheets to the Philadelphia Regional Office, which requested that the information set forth on the spread sheets be transferred to a different format. Later in October 1991, Ms. Flaherty prepared and submitted to Mr. Weitz the information in the format requested, and also provided Mr. Weitz with analyses of operating loans she had prepared in response to questions that had arisen.[22] In preparing the restatements and operating loan analyses, Ms. Flaherty relied on the audited financial statements and auditor workpapers, to the extent they were available,[23] and in doing so, went back to the Projects' inceptions.[24] In

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[21]The Audit Report expressly included the recommendation that CMC recalculate surplus cash and provide supporting documentation. AR-1 at 16.

[22]Whether or not Mr. Weitz submitted the restatements directly to the field offices, they were ultimately received and reviewed by those offices. *See, e.g.*, Tr. 575-76; Finding No. 12, *infra*.

[23]Ms. Flaherty had a "majority" of the financial statements at this time. Tr. 1307-08. She also had documents from the files of Freedman and Fuller - a predecessor accounting firm - that had been transferred to Miller and Benz (later Benz, Flaherty and Kreber) when it was retained to perform audit work for the Projects. Ms. Flaherty also obtained documents from Mr. Weitz and Mr. Shah of CMC. Ms. Flaherty did not request or obtain any documents directly from Resnick, Fedder and Silverman, the original independent accountants for the projects. It was only after she had performed her analyses of the operating loans that Ms. Flaherty met in 1992 with David Resnick, Senior Partner in Resnick, Fedder and Silverman. Mr. Resnick advised Ms. Flaherty that his firm had traced the operating loans to source documents and had determined that they had applied appropriate audit procedures. Ms. Flaherty believes that she had sufficient information upon which to prepare the restatements, and that she fully disclosed the limited purpose for which they were prepared and the limited scope of the information which had been examined. Tr. 194-97, 237, 243-47, 258-59, 270-71, 292-93. Indeed, the cover letters by which Ms. Flaherty transmitted the restatements of surplus cash and the restated balance sheets expressly stated that they were to be used only for their limited intended purpose. The letters also contained the following disclaimer:

> Because the above procedures did not constitute an audit conducted in accordance with generally accepted auditing standards, we do not express an opinion on [the restated balance sheets/restated surplus cash schedules]. In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the specified items should not be adjusted as detailed in [the restated balance sheets/restated surplus cash statements]. Had we performed additional procedures or had we made an audit of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. This report relates only to the items specified above and does not extend to any financial statements of the above referenced partnerships taken as a whole.

AR-5A; AR-5B.

response to another Audit finding, Ms. Flaherty also segregated partnership activity from Project activity. In distinguishing partnership from Project liabilities, if there was a gap in the workpapers she relied upon, Ms. Flaherty gave the benefit of the doubt to the Project. Mr. Weitz provided the materials she prepared to the Regional Office.[25] Tr. 188-93,

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[24]It was necessary to go back to the inception of each Project since the calculation of limited distributions accrues from year to year, and any error made early-on would carryover unless ascertained and corrected. The only source for that inquiry was the annual audited financial statements dating back to the Projects' inceptions. Tr. 1214-15.

[25]Not until the LDP conference on December 7, 1992, discussed *infra*, were Ms. Flaherty and Mr. Weitz provided with a response to the restatements that had been submitted in October 1991. Tr. 1218.

241-42, 245-46, 259, 265, 269-71, 290-91, 1213-19, 1254-55, 1279-80, 1299, 1307-08; AR-5A; AR-5B.

12. In October 1991, Ms. Flaherty met with representatives of the Baltimore Field Office.[26] During that meeting, in response to a request made by Diana Brown of the Baltimore Office, Ms. Flaherty gave the HUD representatives copies of the workpapers concerning Pemberton Manor that she had relied upon in preparing the restatements of surplus cash and the restated balance sheets. She also provided schedules of operating loans that she had prepared for Pemberton Manor, which was her attempt to analyze the work done by Resnick, Fedder and Silverman, the original accountants. Ms. Flaherty specifically told those in attendance that she did not have the original source documents, that the schedules of operating loans were not complete analyses, and that they should not be relied upon.[27] Tr. 193-94, 211, 221, 246-47, 260, 291-92, 1233, 1309-10; AR-8.

13. Mr. Weitz attempted to meet with Sidney Severe, the Regional Director of Housing, and his staff to discuss the Audit, but no such meetings were held. Mr. Severe's office took the position that during audit resolution, the "merits" of the audit could not be "debated."[28] Based on the belief of staff involved in the audit resolution that the information necessary to recommend that the RIGA close the outstanding audit findings was not forthcoming from Mr. Weitz, HUD's Philadelphia Regional Office issued a Limited Denial of Participation ("LDP") against him on June 2, 1992. An LDP would not have resolved the outstanding audit findings. Rather, the LDP was intended to "accelerate" audit resolution and to "put forward the seriousness that the Department viewed the resolution of the audit." Tr. 300, 307-10, 343-45, 353-54, 356-57, 361-62.

14. In the fall of 1992, Mr. Severe appointed William Pelley[29] of the Regional Office to coordinate audit resolution with the three field offices.[30] Because limited progress toward audit resolution had taken place and the field office managers believed that a uniform and coordinated effort was necessary, the managers requested Regional

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[26]Once the Audit Report was issued, Mr. Weitz' dealings with the Baltimore Office became "extremely difficult," as every interaction "became almost adversarial in nature." Tr. 95-96.

[27]Ms. Flaherty never received a response to her submission from the Baltimore Office. Tr. 1233.

[28]Mr. Severe would refer back to the RIGA only a finding by his office that "the IG issued an audit that was based upon a false conclusion or a regulation or a process that was erroneously picked up," or that an audit had been "predicated upon. . .a handbook that was nonexistent or a change that had taken place prior to the audit being issued that changed the process. . . that the IG was not aware of. . . ." Tr. 354.

[29]Mr. Pelley was not called to testify at the hearing.

[30]Once audit resolution was coordinated at the Regional Office level, field office involvement was limited to providing documents to and answering questions posed by the Regional Office. Tr. 506, 584.

Office involvement. Mr. Severe later replaced Mr. Pelley with Pamela Bullock,[31] a Regional Insured Multifamily Housing and Loan Specialist, who he believed had more detailed technical knowledge of loan management processing. Tr. 300-01, 316, 506, 569-70.

[31] Although Ms. Bullock was listed by the Government as a person it expected to call as a witness concerning audit resolution, she was not called to testify at the hearing. *See* Government's List of Witnesses (March 15, 1994).

15. An informal conference on the LDP was held on December 7, 1992. At the conference, the HUD representatives were provided with additional materials by Mr. Weitz. Ms. Flaherty explained how she had recalculated surplus cash. It was agreed that Ms. Flaherty would arrange to meet with Jean Mitrovitch of the Richmond Office to further discuss the surplus cash computations.[32] After Mr. Weitz requested that representatives of the other field offices attend the meeting, Mr. Pelley refused such a joint meeting, and directed that Ms. Mitrovitch instead have a telephone conference with Ms. Flaherty. After Ms. Flaherty had answered some preliminary questions posed by Ms. Mitrovitch in preparation for the conference, the telephone conference itself was canceled by Mr. Pelley, on the advice of counsel.[33] Tr. 310, 508, 572, 1219-24, 1310; AR-17.

16. The LDP was affirmed on February 10, 1993, and Mr. Weitz appealed. The case was assigned to Administrative Judge Timothy J. Greszko of the HUD Board of Contract Appeals. By Order dated March 29, 1993, Judge Greszko notified the parties that the proceeding had been docketed as HUDBCA No. 94-G-D38, Docket No. 93-2000-DB(LDP). Exhibit 1 to Respondents' Motion to Dismiss Amended Complaint.

17. In May 1993, Bruce E. Ward, newly hired Regional Comptroller of Region III, was assigned by Harry W. Staller, Deputy Regional Administrator, Region III, to take the lead in resolving certain outstanding audit findings.[34] Mr. Ward determined that he was to address two issues: (1) whether the projects had generated sufficient surplus cash during the period of their operation to fund the payment of distributions, and (2) whether the distributions identified in the Audit Report were allowable repayments of operating advances as claimed by CMC. In framing these issues, Mr. Ward relied upon the restated Balance Sheets and restated Computations of Surplus Cash, Distributions and Residual Receipts that had been submitted to HUD by Mr. Weitz and had been prepared by Ms. Flaherty. Ward Testimony at 8-10; Tr. 315, 506; AR-5A; AR-5B.

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[32]To the extent Ms. Flaherty's depiction of the events surrounding the Richmond meeting differs from that of Ms. Mitrovitch, I have credited Ms. Flaherty's testimony. As discussed *infra* nn.64 and 73, two significant aspects of Ms. Mitrovitch's hearing testimony undermined her credibility. In contrast, Ms. Flaherty's testimony was completely candid, forthright and consistent.

[33]Until her meeting with Mr. Ward on June 7, 1993, no one from HUD discussed Ms. Flaherty's surplus cash computations with her. Tr. 1224. Moreover, Ms. Mitrovitch never analyzed the materials provided at the December 1992 conference because she had expected to discuss them at her meeting with Ms. Flaherty, which was later canceled and at which she also assumed that Ms. Flaherty would bring a complete set of financial statements. Tr. 572, 578-79.

[34]As discussed *infra*, Mr. Ward was not considered an expert witness for the purposes of this proceeding. Mr. Ward is a Certified Public Accountant ("CPA") with general accounting and auditing experience, and has been a HUD employee only since January 10, 1993, when he was hired as the Regional Comptroller for Region III. Testimony of Accounting Witness Bruce E. Ward ("Ward Testimony") at 5-6.

18. Upon receipt of his assignment, Mr. Ward worked closely with Ms. Bullock. Because Mr. Ward was a recently hired HUD employee, unfamiliar with HUD's asset management and loan processing procedures, Mr. Severe and Thomas Langston, then the Chief of loan management in the Regional Office, reviewed Mr. Ward's proposed analysis at the outset. Tr. 315-320.

19. In late May 1993, Mr. Ward telephoned Ms. Flaherty to arrange a meeting. By letter dated May 26, 1993, Mr. Ward advised Mr. Weitz that he had spoken with Ms. Flaherty[35] and had arranged to meet with her and the three field office representatives on June 2 and 3, 1993.[36] In requesting that Mr. Weitz allow the meeting to proceed, Mr. Ward stated, "[o]ur staff personnel who are responsible for your projects and have what I believe are valid questions, should be allowed the opportunity to have their questions answered by the individual who has the answers." Tr. 1311; AR-30.

20. By its own terms the LDP expired on June 2, 1993.[37] On that same day, Mr. Severe and Mr. Ward met with Mr. Weitz in Philadelphia. During that meeting, which was initiated by Mr. Weitz, Mr. Weitz expressed his willingness to make his books and records available to Mr. Ward and Ms. Bullock. Mr. Severe deemed the meeting to "reactivate" audit resolution, which until that point had not been progressing forward. Ward Testimony at 11-16; AR-11; Tr. 308-09, 315.

[35]According to Ms. Mitrovitch, HUD staff "is not permitted to even contact a CPA without the owner or agent's permission because [HUD staff] is not permitted to incur additional costs for a project." Tr. 510.

[36]As detailed *infra*, the meeting was actually held on June 7, 1993.

[37]Mr. Weitz has continued to appeal the LDP, even after its expiration, because the very fact of its imposition will affect his ability to participate in the future in HUD programs.

21. On June 7, 1993, Ms. Flaherty met with Mr. Ward and Ms. Bullock. Ms. Flaherty gave Mr. Ward and Ms. Bullock copies of the documentation she had provided to the Baltimore Office in October 1991 pertaining to Pemberton Manor, as well as documents pertaining to the other Projects. The documentation included Resnick, Fedder and Silverman workpapers Ms. Flaherty had in her possession. During the meeting, two hours was spent discussing Pemberton Manor reclassification entries listed on the documentation. Ms. Flaherty told Mr. Ward that her work on the Pemberton Manor operating loans was "a preliminary attempt. . .to piece together the operating loans," and that "it should not be relied upon" because she had not performed the underlying audits.[38] Ms. Flaherty also told Mr. Ward that questions regarding the reclassification of certain development fees as operating advances should be discussed with "the Resnick firm since they had done all of the work." Mr. Ward also questioned whether operating advances had been recorded on the Projects' books. Ms. Flaherty showed Mr. Ward some of the general ledgers in response to the inquiry. Mr. Ward agreed that the advances were reflected on the ledgers, and Ms. Flaherty told him that she would send him copies of the relevant pages the next day by overnight mail. Ms. Flaherty also pointed out to Mr. Ward and Ms. Bullock that Leesburg Manor had been included in the distribution finding, despite the fact that it was a profit-motivated project. Mr. Ward asked Ms. Bullock if the Audit Report was wrong, Ms. Bullock replied that it looked like it was, and they stated that they would look into the matter. When the meeting concluded, Ms. Flaherty understood that the issue of reclassification entries being used to differentiate between the payment of operating loans and the payment of development had been resolved.[39] She also understood that conditioned on Mr. Weitz' approval, she would prepare two additional schedules, one for surplus cash and one for operating loans.[40] Tr. 205-08, 211-22, 245-46, 260, 1224-29, 1231-38, 1255-59, 1311-12; AR-8.

22. On June 10, 1993, Ms. Flaherty received a letter by facsimile from Mr. Ward. Ms. Flaherty was upset by the letter, believing that it accused her of withholding information despite her having been cooperative, consistent with Mr. Weitz' instructions. Upon receipt of the letter, Ms. Flaherty telephoned Mr. Ward. She conveyed her distress with his letter, and explained that she had not returned a previous phone call because she had been out of the office. Moreover, copies of general ledger sheets that she had promised to send Mr. Ward, but that he had not received, had mistakenly been

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[38]Ms. Flaherty stated, "I didn't perform these audits. . .I am a third party 20 years later looking at workpapers trying to analyze them." Tr. 224.

[39]These reclassifications are discussed *infra*, under the heading Count I.

[40]Following the meeting, Ms. Flaherty advised Mr. Weitz of what had transpired. Mr. Weitz did not approve the preparation of the schedules because he believed the information was already set forth in the annual financial statements. After discussing the matter with Mr. Weitz, Ms. Flaherty agreed with Mr. Weitz' assessment, particularly given her assumption that Mr. Ward had access to all the financial statements, either through the field offices or from Mr. Weitz. Tr. 1255-57, 1311-12.

sent by regular mail rather than overnight delivery. She also explained that she could not send him a complete copy of the file containing the workpapers they had looked at during the June 7 meeting because they were Resnick, Fedder and Silverman workpapers and were not in her possession. She told him that such a request would have to be made to Mr. Weitz. AR-6; Tr. 1229, 1238-43.

23. By letter to Ms. Flaherty, dated June 14, 1993, Mr. Ward set forth his understanding of their June 10 telephone conversation, as well as a conversation they had had on June 11. AR-7. Ms. Flaherty stated her belief that the letter was an unfair characterization of what had taken place, as follows:

> [F]rom the conversations and everything I determined that Mr. Ward hadn't yet made the distinction on what was my workpaper and what was the Resnick Fedder firm and a lot of the things that I was saying to him he was getting convoluted on or didn't understand them.

Tr. 1244.

24. By letter to Mr. Ward, dated June 21, 1993, Mr. Weitz attempted to "define" what he believed were the issues which needed to be resolved during audit resolution. Mr. Weitz stated:

> I have reviewed your letters addressed to Kathy Flaherty concerning your joint efforts to resolve the I.G. Audit and related matters. It appears that we have strayed from the course we agreed upon at our meeting in Philadelphia with Mr. Staller, Mr. Severe and you on June 2.
>
> It is my clear recollection that your visit with Pam Bullock and Kathy Flaherty was to specifically review her methodology and workpapers for the restated surplus cash prior to Ms. Flaherty's meeting with your loan servicers. Further, we specifically agreed not to delve into the particulars of the operating loans and advances made by the general partners because, as I stated in that meeting, many of the source documents would be 18, 19 or 20 years old and were probably non-existent. As you should also be aware, the issue of the operating loan advances was part of the original I.G. Audit process, yet, in the final I.G. Audit report, there were no findings concerning the operating loans and advances. Therefore, I do not think it is productive to attempt to open a new matter that is not the subject of the I.G. Audit report or which is impossible of being resolved by production of <u>all</u> the source documents (although many have been obtained and turned over to HUD).
>
> We need to come up with another approach to satisfy HUD, the

> R.I.G.A. and the undersigned. I would welcome an opportunity to discuss any thoughts that you have and to make some suggestions of my own. Please let me hear from you by phone as soon as possible to see if a resolution can be achieved and concurred in by R.I.G.A.

GX-36.

25. By letter dated June 23, 1993, Mr. Ward responded to Mr. Weitz' June 21 letter. Mr. Ward disputed the contention that they had strayed from the course, as "it was you who officially responded to the OIG auditors and stated that the money withdrawn from the projects was not 'ineligible distributions' as the OIG had stated, but rather it was repayment of operating advances." Mr. Ward acknowledged Mr. Weitz' concern that many source documents were old and nonexistent, and stated,

> However, we know that the CPA workpapers exist. Your CPA showed them to us and stated that she would have no problem making a copy of them for us. But you have not allowed her to do that. These workpapers are readily available and not difficult to copy. If you truly want to cooperate and resolve your audit, we do not understand why you have not provided a copy of them to us.

AR-2 (emphasis in original).

26. On July 8, 1993, Mr. Ward met with Mr. Weitz and Ms. Flaherty in Mr. Weitz' office.[41] Mr. Ward had prepared draft findings which he brought to the meeting for Mr. Weitz' review. At that meeting, focus was given to Mr. Ward's analysis of Pemberton Manor. Mr. Weitz and Ms. Flaherty pointed out some computational errors, which Ms. Flaherty understood were to be corrected by Mr. Ward. Mr. Ward also questioned Mr. Weitz on a letter related to an Operating Loss Loan,[42] stating that the proceeds should have been used to repair construction defects at Pemberton Manor. This was the first time Mr. Weitz was made aware that anyone was questioning the loan. Mr. Weitz responded that the loan proceeds were used to cover operating deficits which had already been covered by advances. Mr. Weitz gave Mr. Ward original financial statements from inception through 1990 for Pemberton Manor. He also gave Mr. Ward copies of all the partnership agreements. Mr. Weitz and Ms. Flaherty understood that Mr. Ward would use the Pemberton Manor financial statements to create a pro forma analysis, which once reviewed and agreed to by Mr. Weitz, would be applied to the other Projects. Mr. Ward never forwarded the Pemberton Manor pro forma to Mr.

[41] After the June 23, 1993, letter and before the July 8, 1993, meeting, Mr. Weitz had a telephone conversation with Mr. Severe. Mr. Weitz called to see if Mr. Severe was aware that, in his view, Mr. Ward had expanded the audit resolution process to a point where it had been "breaking down" and was becoming "adversarial." Tr. 1595-96.

[42] Details concerning the Operating Loss Loan are set forth *infra*, Count II.

Weitz.[43] Tr. 1245-49, 1259-60, 1574-76, 1596-97, 1599-1600, 1605, 1608-09; Ward Testimony at 15-16.

27. By letter to Mr. Weitz dated July 12, 1993, Mr. Ward followed-up on the July 8, 1993, meeting. Mr. Weitz was "astonished" by the letter's suggestion that he return $266,638 to Pemberton Manor, and considered the letter and "accusation" "the straw that broke the camel's back." Mr. Weitz did not communicate his reaction to Mr. Ward, as at that point, his "relationship with Mr. Ward took a sudden turn," and he did not want to antagonize him. OLL-16; Tr. 1600-02, 1606.

28. By way of an electronic mail message dated July 12, 1993, Georjan Overman of the Office of General Counsel, "requested that Housing discontinue any negotiations with the subject principals pending their notification advising [Housing] otherwise." By no later than July 20, 1993, the workpapers related to the RIGA Audit that had been in the RIGA's possession were "loaned" to the Office of General Counsel. R-20; R-22; Tr. 1512.

29. On July 13, 1993, Ms. Flaherty had a brief telephone conversation with Mr. Ward.[44] Mr. Ward asked Ms. Flaherty questions concerning program requirements, including limited dividends. From this conversation, Ms. Flaherty concluded that Mr. Ward did not have a good understanding of the HUD program. Tr. 1249-50.

30. On July 13, 1993, Ms. Flaherty sent a letter to Mr. Ward by facsimile, to clarify the items they had discussed during their phone conversation.[45] The letter described basic principles involving the payment of management fees, calculation of limited dividends, and nature and purpose of partnership agreements. AR-25; Tr. 1250-51.

31. By memorandum dated July 20, 1993, Edward F. Momorella, the Regional Inspector General for Audit, advised Mr. Staller that "[i]n order to properly evaluate the documentation provided, it will be necessary to refer to the workpapers for the subject audit." Mr. Momorella further stated that since the workpapers had been forwarded to the Office of General Counsel, his office would review the documentation when the

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[43]Mr. Weitz acknowledged that at some point, Mr. Ward did write to him requesting the financial statements for the other Projects. However, that request was made after Mr. Weitz received Mr. Ward's July 12, 1993, letter, discussed *infra*, and had determined that the two had reached an impasse. Tr. 1606.

[44]This was Ms. Flaherty's last conversation with Mr. Ward until January 1994. Tr. 1251.

[45]Mr. Ward testified that he did not receive the facsimile and that his office has no record of it being received. He further testified that he was "astonished" by the content of the letter and considered it "incredible" because he had already "gotten the education [he] needed" and would not at the time have been asking such basic questions. Tr. 660-61, 670. Since I have found Ms. Flaherty to be a credible witness, I credit her testimony that the letter was sent. Tr. 1250-51.

workpapers were returned.[46] R-22.

[46]Once the workpapers were transferred to the Office of General Counsel, the RIGA could no longer review them and proceed to closure of any audit findings. Tr. 1468-69, 1492.

32. The work performed by Mr. Ward during the Summer of 1993 culminated in the issuance of a report of his findings ("Ward Report") on August 25, 1993. The findings were based almost exclusively on the restated Balance Sheets and restated Computations of Surplus Cash, Distributions and Residual Receipts that had been prepared by Ms. Flaherty and provided by Mr. Weitz. Mr. Ward did not have a complete set of audited financial statements when he prepared his report.[47] Mr. Ward did not contact Resnick, Fedder and Silverman in preparing his report. Prior to issuance of the report, Mr. Ward had consulted with Jean Mitrovitch, David Cohen and Judy Heyde, the loan servicers in the three relevant field offices, to ascertain whether his analysis was consistent with HUD asset management and loan servicing procedures. The three field office representatives concurred in his findings.[48] AR-10; Ward Testimony at 16-17; Tr. 316-17, 337, 359-61, 519-20, 600-02, 617-18, 626, 687, 699-702, 711, 1248, 1270, 1628-29.

33. By memorandum dated September 2, 1993, Mr. Severe requested from Mr. Momorella authorization to reclassify the Audit as "in litigation." Mr. Severe based his request on Mr. Momorella's July 20, 1993, memorandum and the July 12, 1993, electronic mail message from the General Counsel's Office. Mr. Severe further stated that "[i]n light of this present situation our efforts to resolve the remaining findings will be delayed" and that his office would advise Mr. Momorella "of any changes in the status of the litigation efforts as we receive them." R-20.

34. Various disputes arose during the discovery process of the LDP proceeding regarding the responses of the Government to the Respondents' requests. Exhibits 6, 7, and 9 to Respondent's Motion to Dismiss Amended Complaint. By Motion dated September 8, 1993, Respondents sought dismissal of the LDP *ab initio*, and, in the alternative, an order compelling the Government to respond to their discovery requests. Exhibit 9 To Respondent's Motion to Dismiss Amended Complaint. By Order dated September 10, 1993, Judge Greszko denied Respondents' request that he dismiss the

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[47]All of the witnesses who addressed the issue at the hearing, including the Government's witnesses, consistently testified that to properly perform the type of analysis undertaken by Mr. Ward, it was necessary to review the audited financial statements for all the Projects, dating back to inception. Indeed, in her review of Mr. Ward's report, which she concluded was a "masterful" work, Ms. Mitrovitch assumed that Mr. Ward had utilized such financial reports, and did not see how he could have done his analysis if he had not looked at the financial statements. Judy Heyde, the HUD loan analyst for Essex House, made the same assumption. *See, e.g.*, Tr. 501-08, 514, 517-19, 539, 574, 577, 602-03, 784, 793-94, 1271. Mr. Guss stated that to accurately calculate surplus cash, financial statements going back to inception must be reviewed. Tr. 1516-17. However, Mr. Ward acknowledged at the hearing that despite gaining access to all the financial statements during the course of this proceeding, he has yet to review the statements. Tr. 701-02.

[48]Ms. Mitrovitch had met with Mr. Ward so that he could present his analysis and draft findings. Having recognized that Mr. Ward was new to HUD and had been asked to undertake a complex task, she felt she had to be convinced that he understood the "HUD way" in order to concur in his findings. *See, e.g.*, Tr. 598-602, 617-18, 624-26.

LDP, but ordered the Government, by virtue of 14 enumerated directives, to comply fully with Respondents' discovery requests. Exhibit 10 to Respondents' Motion to Dismiss Amended Complaint.

35. The Ward Report was transmitted to Mr. Weitz on September 16, 1993, along with a letter prepared by Mr. Ward and signed by Harry M. Staller, the Deputy Regional Administrator. The letter stated, *inter alia*:

> In conclusion, we found that your recalculated surplus cash amounts fully support the amount of dividends that were recorded as earned. During our review of your recorded operating advances, however, based on the information that you have provided to us to date, we were not able to substantiate the appropriateness of $2,792,497 that you have recorded as operating advances plus interest. Since we can not substantiate this significant amount as representing reasonable and necessary advances for operating expenses, you must pay it back to the projects, less outstanding allowable accrued amounts owed to you, which as of the end of 1990 amounted to a net required payment back to the projects of $1,191,261. Once you have paid this amount to the projects, or have agreed to a repayment plan which is acceptable to HUD, the Audit will be considered fully resolved.[49]

AR-11.

36. By memorandum dated September 24, 1993, Mr. Momorella advised Mr. Staller that his office had reviewed Mr. Severe's September 2, 1993, memorandum and concurred with the decision to classify the Audit as being in litigation "-- implementation suspended."[50] R-21.

37. On October 13, 1993, in the belief that the Government had not complied with Judge Greszko's Sept 10, 1993, Order, Respondents renewed their Motion to Dismiss the LDP *ab initio*. Exhibit 11 to Respondent's Motion to Dismiss Amended Complaint.

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[49]According to Mr. Guss, although he concurred in the letter "[i]n the absence of Mr. Momorella and with his permission," he did not "authorize" the statement that payment of nearly $1.2 million would fully resolve the audit. Tr. 1483-85. *See also* Tr. 1497-99, 1512.

[50]Messrs. Severe and Momorella stated that the designation "in litigation" reported the Audit's status within HUD, and did not purport to represent it had halted. However, because the Office of Housing could not have recommended that the audit be closed once litigation ensued, I conclude that the designation memorialized the fact that once litigation began, audit resolution came to a standstill. Tr. 320-21, 327-29, 351, 355-56, 1449-51, 1458-61, 1467-68.

38. On October 15, 1993, Judge Greszko issued a Notice of Oral Argument, requiring the Government to respond by noon on October 22, 1993, to Respondents' renewed Motion to Dismiss the LDP . Argument was scheduled for October 26, 1993, at a hearing to be conducted on the record. Exhibit 12 to Respondent's Motion to Dismiss Amended Complaint.

39. A few days prior to October 22, 1993, William M. Heyman, Director of HUD's Office of Lender Activities and Land Sales Registration, met with attorneys from the Office of General Counsel involved in the LDP proceeding. Jim Anderson, then the Acting Director of the Office of Lender Activities and Land Sales Registration's Participation and Compliance Division, also attended the meeting. The discussion that ensued "centered around the underlying facts of a suspension and proposed debarment." At the time of the meeting, Mr. Heyman was aware of the pending LDP proceeding before Judge Greszko, but did not know that the Government was to respond to Respondents' Motion to Dismiss the LDP by noon on October 22, 1993, or that argument had been scheduled for October 26, 1993. Deposition Transcript of William M. Heyman (Attached to Respondents' April 22, 1994, Response to Government's Motion to Strike Affirmative Defense) ("Heyman Dep. Tr.") at 7, 18-23, 39-40.

40. On October 22, 1993, the day the Government was to reply to Respondents' renewed Motion to Dismiss the LDP, the letter suspending Respondents and proposing their debarment was issued. The letter was issued by the Assistant Secretary for Housing-Federal Housing Commissioner after having been reviewed and concurred in by Mr. Heyman that same day. When Mr. Heyman concurred in the letter, he relied only on the conversation he had previously had with the attorneys from the Office of General Counsel. Mr. Heyman had no personal knowledge as to the accuracy of the facts alleged in the letter to support the suspension and proposed debarment, nor was he aware of any program staff member in the Office of Housing who had such personal knowledge. Letter from Engel for Retsinas to Respondent (Oct. 22, 1993); Exhibit 12 to Respondent's Motion to Dismiss Amended Complaint; Heyman Dep. Tr. 17-18, 24-25, 43-44, 51-52, 60-62.

41. On the same day the debarment and suspension letter issued, the Government filed with Judge Greszko a Motion to Dismiss the LDP with prejudice. In its Motion, the Government asserted that the LDP had been superseded by the notice of suspension and proposed debarment. Exhibit 13 to Respondent's Motion to Dismiss.

42. By Order dated October 22, 1993, Judge Greszko stayed the oral argument on the Government's Motion to Dismiss the LDP that had been scheduled for October 26, 1993. Exhibit 12 to Respondent's Motion to Dismiss; Order (HUDBCA No. 94-G-D3, Docket No. 93-20000-DB (Oct. 22, 1993)).

43. By Ruling and Order dated November 17, 1993, Judge Greszko granted in part and denied in part the Government's October 22, 1993 Motion to Dismiss the LDP.

Judge Greszko dismissed as superseded the LDP charge of ineligible distribution of $223,965 in Essex House funds, which was included in the suspension. Having concluded that the remaining LDP charges were not clearly common to the suspension, he denied the Government's Motion as to the remaining charges. Judge Greszko lifted the stay of the LDP proceeding that had been in effect and ordered the filing of further submissions. Ruling and Order on Government's Motion to Dismiss (HUDBCA No. 93-G-D38, Docket No. 93-2000-DB(LDP) Nov. 17, 1993).

44. By letter dated November 4, 1993, and prepared by Mr. Ward, Mr. Staller responded to an October 15, 1993, letter from Mr. Weitz' counsel concerning the Ward Report. In addition to addressing questions regarding the substantive conclusions reached in the Report, Mr. Staller addressed the issue of audit resolution. In doing so, Mr. Staller stated:

> There are two issues remaining. One, all of the questioned $2.7 million must be shown to be advances/loans made for "reasonable and necessary operating expenses;" and two, to the extent that this is not the case, then the amounts must be paid back to the projects and then put into restricted residual receipts accounts. Then the audit will be considered closed. There are no remaining substantive issues. . . .

AR-34. The letter concluded with a reiteration of the September 16, 1993, letter which accompanied transmittal of the Ward Report, and stated, "[n]ow that we have responded to your letter, you should be in a position to achieve resolution of your audit." *Id*.[51]

45. On November 19, 1993, Respondents requested a hearing to appeal the suspension and proposed debarment. Order (Nov. 24, 1993).

46. On November 19, 1993, Mr. Ward issued revisions to his Report to reflect errors of omission and computation. These errors understated the purported amount of repayments of ineligible advances that Respondent had made with project funds by

[51] Although Mr. Guss concurred in the letter, he testified that even if Mr. Weitz had paid the nearly $1.2 million, the RIGA would not necessarily have agreed to full closure of the audit findings. Tr. 1455-58, 1485-88. *See also* Tr. 1498-99, 1512. On the other hand, Mr. Momorella, the RIGA, first testified that the letter represented the Department's position and that Mr. Guss' concurrence indicated that RIGA staff had no problem with the content of the letter. Tr. 1455-58. When pressed, he couldn't, or wouldn't, say what his position was on the concurrence. Tr. 1469-73.

$23,177. AR-12; Ward Testimony at 17-18.

47. On November 22, 1993, Mr. Ward and Ms. Overman met with Jeffrey Barsky and Alan Rosenthal, principals at Resnick, Fedder and Silverman, at the firm's office. At Mr. Barsky's request, Mr. Ward provided him with a copy of certain computer schedules. Mr. Ward did not ask to meet with William D. Riley, managing principal of the firm's Baltimore office, or Mr. Resnick.[52] During the meeting or the lunch discussion which followed, Mr. Barsky advised Mr. Ward that Resnick, Fedder and Silverman ceased doing audit work for Mr. Weitz in 1986, but he did not advise Mr. Ward why the relationship had terminated.[53] Tr. 1053-54, 1444-45.

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[52]Mr. Ward testified that he may have asked to meet with Messrs. Resnick and Riley on November 22, 1993. Mr. Barsky expressly and forthrighly testified that Mr. Ward made no such request. I credit that testimony. Moreover, both Messrs. Resnick and Riley testified that if asked, they would have been perfectly willing to meet with Mr. Ward. The first time Mr. Ward spoke with Mr. Resnick was one week prior to the start of the hearing (tr. 985-86), and Mr. Ward has never met with Mr. Riley nor has he ever contacted Mr. Riley (tr. 671, 1081). Mr. Ward's explanation for not having met with Mr. Resnick and Mr. Riley in preparing his report is that "[t]hey were not provided to me to speak to." Tr. 671.

[53]Messrs. Barsky and Rosenthal expressly repudiated Mr. Ward's testimony that either had told Mr. Ward that the firm had terminated its relationhip with Mr. Weitz because the firm was no longer "willing to do the kinds of things anymore that he wanted them to do. . . ." Tr. 705. *See also* Tr. 1042-43, 1052-53, 1444-45. In doing so, they both credibly testified that they did not even know at the time they had met with Mr. Ward why the firm no longer did audit work for Mr. Weitz. After listening to Mr. Resnick's hearing testimony, Mr. Barsky learned for the first time why Mr. Weitz and Mr. Resnick had mutually agreed to end the relationship. They did so for reasons having nothing to do with Mr. Ward's uncorroborated accusation. Attorney Overman, the only other person present when the statement was purportedly made, did not take the stand to testify. Tr. 984-85, 995, 1042-43, 1053, 1445.

48. Messrs. Barsky and Rosenthal prepared and reviewed a letter that was sent to Mr. Ward on December 9, 1993. The letter included explanations of certain workpapers that had been prepared by Resnick, Fedder and Silverman. After the letter was sent, Mr. Barsky had conversations with Mr. Ward concerning the letter's content. Tr. 1046.[54]

49. On December 16, 1993, the Government filed a Complaint in the suspension and debarment proceeding. The Complaint concerned Mr. Weitz' conduct with respect

[54] According to Mr. Barsky, any CPA in performing professional services is ethically obligated "to disclose all relevant facts and circumstances surrounding any work that he is doing." Mr. Barsky testified that he was surprised that Mr. Ward did not address the points made in the letter in his written direct testimony in this proceeeding because Mr. Barsky considered the explanations set forth in the letter to be "relevant to the issues at hand." Tr. 1046-47.

to six of the seven projects which had been the subject of the RIGA Audit Report. The six counts in the Complaint are summarized as follows:

> Count I. The willful violation of regulations and the Projects' Regulatory Agreements through the distribution of $1,191,261 in project funds;
>
> Count II. The willful violation of the Pemberton Manor Regulatory Agreement, regulations, and HUD requirements in connection with the procurement of a $292,500 Operating Loss Loan;
>
> Count III. The willful violation of the Essex House Regulatory Agreement and HUD regulations through the alleged payment of a $212,033 "note payable" from project funds;
>
> Count IV. The willful violation of project Regulatory Agreements by failing to maintain Essex House and Pemberton Manor in good repair and condition;
>
> Count V. The willful violation of the Essex House Regulatory Agreement through the distribution of $223,965 in project funds when certain high urgency deficiencies, as noted on the then most recent physical inspection report, were not corrected; and
>
> Count VI. The violation of an April 1993 agreement with the Department to obtain financing to repair the structural deficiencies of the Pemberton Manor roofs.[55]

Government's Complaint.

50. Respondents filed their Answer on December 29, 1993. The Answer denied the substantive charges of the Complaint, and set forth 16 separate affirmative defenses, including but not limited to defenses relating solely to the suspension aspect of the Complaint, defenses relating to the failure of the Federal government to work in good faith toward the resolution of the RIGA Audit, and defenses relating to allegations that the October 22, 1993, letter was not issued in good faith, but rather to extricate the Government from the possible dismissal of the related LDP appeal. Respondents' Answer to Complaint (Dec. 29, 1993).

51. In January 1994, Mr. Ward telephoned Ms. Flaherty and stated that he wanted to review the workpapers Ms. Flaherty had that pertained to the operating advances. Ms. Flaherty advised Mr. Ward that she had given him everything she had, but Mr. Ward was not satisfied. Ms. Flaherty then reiterated that she had already given him everything in her possession and that what he was seeking were Resnick, Fedder

[55] As discussed *infra*, Count VI was dropped by the Government on May 4, 1994.

and Silverman workpapers which she did not have. Ms. Flaherty suggested that Mr. Ward contact Mr. Weitz or Mr. Resnick. Sometime later that month, Mr. Ward, for the first time, went to Mr. Resnick's office to review documents on microfiche.[56] Tr. 410-11, 1251-52.

52. On January 4, 1994, Judge Greszko granted the Government's request for certification to the Secretary for review of the question whether the notice of suspension and proposed debarment superseded the LDP so as to warrant dismissal of the LDP proceeding. In the Ruling and Order, Judge Greszko stated, *inter alia*:

> Respondents also assert that the superseding suspension was not issued in good faith. As the case relating to Respondents' suspension has been referred to and docketed in the HUD Office of Administrative Law Judges, I cannot address that issue. However, I find substantial evidence in support of Respondents' allegation that the issuance of the superseding suspension was a tactic to avoid a hearing on charges that Government counsel was intentionally failing to comply with the Board's discovery orders. The Notice of Suspension and the Government's Motion to Dismiss the LDP were issued on October 22, 1993, upon the heels of a Motion to Dismiss and Motion for Sanctions, which was filed by Respondents on October 14, 1993. That motion contained serious allegations of intentional, flagrant and continuous violations of this Board's discovery orders by Government counsel which were issued over a period of several months. The motion also alleged that Government counsel had been instructed by a supervisor to simply ignore certain parts of the Board discovery order issued on September 10, 1993, because the order required the Government to "take actions which it typically does not take." Government counsel orally represented to the Board, in a number of prehearing conferences conducted over the course of this proceeding, that the Government would comply with the Board's discovery orders, yet it appears that this commitment may have been repeatedly violated. Government counsel also made a written representation to the Board in a "request for Enlargement of Time Dated September 15, 1993, that, due to illness, the Government needed several additional days "to comply with the [Board's] order dated September 10, 1993." That request was summarily granted by the Board on September 21, 1993. Notwithstanding these representations, Respondents allege that the Government has never fully complied with the Board's September 10, 1993 discovery order, as well as a number of other discovery orders issued by this Board. If

[56]During the course of discovery in this proceeding HUD later obtained copies of these documents. Tr. 412.

> Respondents' allegations are true, they are indeed serious, and raise questions of possible misrepresentation.
>
> On October 15, 1993, in order to resolve these allegations, the Board scheduled a hearing on October 26, 1993 for oral argument on Respondents' Motion to Dismiss and Motion for Sanctions. Government counsel was ordered to file a reply to the Motion on or before October 22, 1993. In lieu of filing a reply, the Government filed its own Motion to Dismiss on October 22, 1993, on the grounds that the LDP had been superseded by a suspension dated October 22, 1993. The Government neither filed a reply to Respondents' Motion, nor informed the Board that it did not intend to file a reply. The timing of the suspension at issue is unfortunate, at best, and evidence of possible abuse of process, at worst, because Government counsel should have known that the issuance of a notice of Respondents' suspension was imminent. Because of the seriousness of Respondents' allegations, I find it necessary, for the purpose of maintaining order in this proceeding, to certify the Board's ruling of November 17, 1993 to the Secretary for review.

Ruling and Order on Government's Request for Certification (HUDBCA No. 93-G-D38, Docket No. 93-2000-DB(LDP)(Jan. 4, 1994)).

53. On January 10, 1994, Respondents filed a Motion to Terminate Suspension and Motion for Immediate Hearing in which they alleged, *inter alia*, that the Complaint did not meet the regulatory requirements for a suspension, and that the Department had not followed the regulatory procedures required before a suspension can be instituted.

54. Following a pre-hearing conference on January 10, 1994, I issued an Order requiring that the Government file its Amended Complaint by January 18, 1994, setting a January 31, 1994, date for the hearing on Respondents' January 10, 1994, Motion, establishing a discovery schedule, and setting June 6, 1994, as the date for the commencement of the hearing on the proposed debarment.

55. The Government filed its Amended Complaint on January 18, 1994. The major changes to the Complaint were the inclusion for the first time of a provision purporting to address the need for immediate suspension, and the narrowing of Count IV to allege that Respondent had failed to maintain in good repair and condition the roof and flashing at Essex House and the roof, trusses, and other underlying roof structure of Pemberton Manor.

56. On January 18, 1994, the Government also filed its Opposition to Respondents' January 10, 1994, Motion, and a Motion to Amend the Pre-Hearing Conference Order of January 11, 1994, which had set the date for the separate suspension hearing. On January 25, 1994, Respondents filed their Opposition to the Government's Motion to Amend the Pre-Hearing Conference Order.

57. On Friday, January 28, 1994, the Government filed a Motion for Stay of the hearing on the suspension. That day, I issued an Order denying both the Government's Motion for Stay and its January 18, 1994, Motion to Amend Pre-Hearing Conference Order. Later that same day, the Government filed a Request for Certification for Interlocutory Appeal to the Secretary and a Motion for Stay, seeking an Order certifying for review by the Secretary the denial of its request to stay the suspension hearing and again requesting a stay of the January 31, 1994, hearing on the suspension. During a telephone conference held late that day, I denied the Government's Request for Certification and Motion to Stay. Early that evening, the Government filed with the Secretary an Emergency Motion for Stay which was granted.

58. As scheduled, on Monday, January 31, 1994, I opened what was to have been a hearing on the suspension. Respondents attended the hearing; the Government did not.[57] I read into the record my Order, dated January 31, 1994. The Order granted Respondents' January 10, 1994, Motion, and thereby terminated the suspension which had been in effect since October 22, 1993. The January 31, 1994, Order stated, *inter alia*:[58]

> Even though the government was given the opportunity to clarify its position, the government has not indicated whether this case merely involves disputed questions of appropriate accounting and building repair problems, or whether the Respondents have done something that involves moral turpitude. Clearly, even assuming that the allegations in the amended complaint are true and that one could find that cause for suspension has been shown, there are no allegations showing an immediate need to suspend Respondents prior to a hearing on their proposed debarment. 24 C.F.R. § 24.400(b). There is not one word to indicate that any maintenance or repair deficiencies (some of which date from June of 1989) are of such serious consequence as to threaten the health or safety of any of the projects' occupants. Moreover, there is not one word that indicates that any of the projects is in such

[57] Early in the morning on January 31, 1994, Respondents filed an Affirmation of Hearing by telecopier and mail stating that they would be prepared for commencement of the hearing as scheduled, and that they would appear at the hearing.

[58] *See also* Transcript of Pre-Hearing Conference (Jan. 31, 1994).

> financial shape that default or any other serious adverse financial consequence is a realistic possibility; or that, if Respondents are found to have taken unlawful distributions from the projects in excess of those to which they are alleged to have been entitled but which they have not elected to take, there is any reasonable likelihood that such sums cannot be recaptured. In short, the allegations in the complaint failed to allege any immediate need for suspension. This is not a case where a respondent has been indicted or convicted, nor is it one where a respondent is alleged to have committed fraud.

59. On January 31, 1994, the Government filed with the Secretary a Petition for Secretarial Review of the January 31, 1994, Order.

60. Respondents filed their Answer to the Amended Complaint on February 7, 1994.

61. On February 14, 1994, the Secretary, through his designee, issued an Order on Interlocutory Ruling. In the Order, the Secretary affirmed Judge Greszko's November 17, 1994, Ruling and Order. The Secretary stated, *inter alia*:

> Having reviewed the Administrative Judge's ruling and the briefs submitted, I conclude that both the Administrative Judge's holding that an LDP hearing is not precluded under applicable regulations, and his factual finding that the suspension does not cover all the same charges as the LDP, are reasonable and not inconsistent with the evidence, law or public policy. I further conclude that allowing a hearing to go forward on these issues would not adversely affect the rights of either Respondents or the Government. Indeed, principles of fundamental fairness would likely require that Respondents be granted a hearing on these issues.

Exhibit 15 to Respondents' Motion to Dismiss Amended Complaint.

62. By letter dated March 7, 1994, Mr. Momorella, the RIGA, advised Ms. Flaherty that, from his review of the financial statements that her firm had prepared for Essex House and Pemberton Manor for years ending September 30, 1992, and September 30, 1993, he concluded that the working papers and audit reports did not adhere to "the standards prescribed by the AICPA or GAO and the requirements of the Consolidated Audit Guide for Audits of HUD Programs, HUD Handbook IG 2000.04." Mr. Momorella requested that Ms. Flaherty provide addenda or corrected reports, "including a description of the action you have taken to correct the deficiencies in your working papers, to [his] office within 60 days of the date of this letter." He further stated, "[f]ailure to comply with our request can result in a referral to the appropriate officials for administrative sanctions."

63. On March 14, 1994, the Secretary, through his designee, denied the Government's Petition for Secretarial Review and affirmed my January 31, 1994, Order.

64. On March 18, 1994, the Government petitioned the Secretary for reconsideration of his March 14, 1994, Order Denying Petition for Secretarial Review. Respondents filed their Opposition to the Government's Petition on March 25, 1994.

65. On April 13, 1994, the Government filed a motion to strike the affirmative defense that the suspension and proposed debarment should be dismissed because they were not filed in good faith, but rather as a tactical maneuver in connection with the LDP proceeding. On April 15, 1994, Respondents filed a Motion to Dismiss Amended Complaint. On April 25, 1994, the Government filed its Opposition to Respondents' Motion to Dismiss.

66. On April 28, 1994, Respondents filed a Motion In Limine, seeking an Order precluding the use of any expert testimony by John O'Connor and John McKeever, employees of the accounting firm of Price Waterhouse, because the Government had not filed any written direct testimony from them as expert witnesses. Mr. O'Connor and Mr. McKeever had been listed as potential witnesses by the Government, and the Government had stated that they would testify to their review of the analysis prepared by Mr. Ward and their independent review of documents provided by Mr. Weitz or by independent accounting firms employed by Mr. Weitz. On May 2, 1992, the Government filed its Response to Respondents' Motion, asserting that Respondents' request was "overly broad and would prejudice HUD because it would preclude Messrs. O'Connor and McKeever from testifying as experts in rebuttal or otherwise as non-experts." On May 2, 1994, I issued an Order granting Respondents' Motion to the extent that it sought to preclude the Government from proffering any *direct* expert testimony of Mr. O'Connor and Mr. McKeever.

67. On May 2, 1994, I issued an Order addressing, *inter alia*, the Government's Motion to Strike Affirmative Defense and Respondents' Motion to Dismiss Amended Complaint. The Order denied the Government's Motion to Strike Affirmative Defense and held Respondents' Motion to Dismiss Amended Complaint in abeyance, until such time as the Government had the opportunity to present its case in chief and Respondents had renewed the Motion.[59] In so ruling, the Order states:

> At the heart of both motions is Respondents' allegation that the instant proceeding was initiated as a tactical maneuver by the Government to extricate itself from the LDP proceeding before Judge Greszko of the HUD Board of Contract Appeals. The

[59]On April 21, 1994, Respondents filed a Request for Permission to Amend Motion to Dismiss. The Request was granted in the May 2, 1994, Order.

> record thusfar presented demands that Respondents' allegation not be ignored. Serious questions are raised by the apparent lack of input by HUD program officials into the recommendation to suspend Respondents and to propose their debarment, and by the fact that the Government was unable to justify its decision to suspend Respondents before this tribunal. The drawing of an inference of Government misconduct from such factors at this stage of the proceeding, however, would be premature, since the Government has yet had an opportunity to present its case in chief.

68. On May 4, 1994, the Government filed a Notice of Withdrawal of Count VI of Government's Amended Complaint. The Government stated that it was withdrawing Count VI because HUD's Baltimore Office was in the process of reviewing a proposal that had been submitted to the HUD Philadelphia Office, dated January 11, 1994, that encompassed a plan for repairing the roof at Pemberton Manor.

69. On May 19, 1994, the Secretary denied the Government's March 18, 1994, Petition for Reconsideration of the Secretary's March 14, 1994, Order. In doing so, the Secretary stated:

> Having once again examined the record and considered the arguments propounded by the Government, I find that there is no reason for further Secretarial consideration of this case. Moreover, I am concerned that the repeated requests for Secretarial intervention have resulted in excessive delay of these proceedings. The Government has sought Secretarial intervention in these matters on four occasions: (1) in opposition to a hearing on the LDP; (2) in opposition to a separate hearing on the suspension; (3) in opposition to the ALJ's termination of the suspension; and (4) in opposition to one of my orders. Although it is quite apparent that the Government disputes the need for a separate hearing for a suspension when the suspension is issued pending completion of debarment proceedings, it is not as readily apparent why holding such a hearing would have serious or irreparable consequences or why immediate Secretarial intervention--and the use of valuable time and resources that accompany Secretarial intervention--was necessary to avoid the prospect of such a hearing. . . .In the future, all parties to a proceeding before a HUD hearing officer--including the Government--should employ the interlocutory appeals procedures only when clearly warranted.

Order Denying Petition for Reconsideration at 7 (May 19, 1994). With regard to termination of the suspension, the Secretary further stated:

> Under the circumstances, the ALJ's actions were appropriate and in accordance with the requirement, at 24 CFR 26.24(a), that the hearing officer make particularized finding of facts. Although he felt constrained to rule on the motion without holding a hearing, the ALJ was effectively ordered to make such a ruling by the Order Staying Proceedings signed on January 28, 1994. Also, he did examine the entire record and made a finding that the Government failed to show an immediate need to suspend Respondents.

Id. at 5 n.3.

70. On May 19, 1994, Respondents filed a Motion to disqualify Mr. Ward as an expert witness. On May 26, 1994, the Government filed its Response to Respondents' Motion, opposing the disqualification of Mr. Ward as an expert witness. At a pre-hearing conference held on May 31, 1994, I granted Respondents' Motion to disqualify Mr. Ward as an expert witness. In so ruling, I found that although Mr. Ward had experience as an accountant and as an auditor, he had no specialized experience with the type of audit issues that are raised in this proceeding and that he had never before engaged in the type of analysis he was assigned to undertake in this case. I further found that he would testify only as a fact witness. Transcript of May 31, 1994, Pre-Hearing Conference at 3-4.

71. At the May 31, 1994, pre-hearing conference, CHRC and the Government agreed that because no material facts remained in dispute, the legal issue whether CHRC is the affiliate of Respondent would be resolved upon the submission of written briefs and documentary evidence. Transcript of May 31, 1994, Pre-Hearing Conference at 29-32, 38-40. CHRC and the Government filed their submissions on June 1, 1994. On June 3, 1994, I issued an Initial Determination of Affiliation concluding that CHRC is an affiliate of Respondent under 24 C.F.R. § 24.105(b).

72. The hearing on the proposed debarment was held in Washington, D.C., on June 6-15, 1994. Neither Mr. O'Connor nor Mr. McKeever of Price Waterhouse was called by the Government to testify at the hearing. At the close of the hearing, Respondents renewed their Motion to Dismiss Amended Complaint. Tr. 1629-30.

73. The majority of the audit findings set forth in the Audit Report have yet to be resolved.[60] Tr. 320.

[60]As discussed *infra*, the Regional Office of Housing had recommended to the RIGA that it close finding number one, but that recommendation was rejected. Tr. 336.

Count I: The Alleged Unauthorized Distribution of Nearly $1.2 Million of Project Funds

74. The Regulatory Agreements require that the limited partnerships submit to HUD annual financial reports, prepared by independent certified public accountants ("IPAs"), within 60 days following the end of each fiscal year.[61] These annual audited financial reports must be certified by both the limited partnership and the IPA. Each limited partnership filed with HUD the annual audited financial reports required by their respective Regulatory Agreements.[62] AR-4A through AR-4C, AR-4E through AR-4F, ¶ 9(e); AR-4D, ¶ 12(e); AR-3 (HUD Handbook 4371.1, ¶¶ 17-18 (Apr. 1974)); NP-6 (HUD Handbook 4370.2, ¶¶ 17-18 (Apr. 1981)); Tr. 43, 45-46, 467-68.

75. The Regulatory Agreements state:

> The Mortgaged property, equipment, buildings, plans, offices, apparatus, devices, books, contracts, records, documents, and other papers relating thereto shall at all times be maintained in reasonable condition for proper audit and shall be subject to examination and inspection at any reasonable time by the Commissioner [Secretary in AR-4D] or his duly authorized agents. Owners shall keep copies of all written contracts or other instruments which affect the mortgaged property, all or any of which may be subject to inspection and examination by the Commissioner [Secretary in AR-4D]. . . .

AR-4A through AR-4C, AR-4E through AR-4F, ¶ 9(c); AR-4D, ¶ 12(c).

76. The Regulatory Agreements for the Projects, except Perry House, provide that:

> Owners shall not without the prior written approval of the Commissioner:

---

[61] Pursuant to record retention policies, HUD field offices periodically purged their files containing the financial statements submitted by the limited partnerships. As a result, the field offices did not have a complete set of financial statements during audit resolution and the time Mr. Ward was preparing his Report upon which Count I is based. Tr. 396-97, 539-42, 578, 782-83. There is no evidence that HUD has an established policy for retention by auditees of the source documents for the financial statements. According to Mr. Riley's practice, he advises clients to keep such records for 5 to 10 years. Tr. 1078-80.

[62] After the Audit Report was issued by the RIGA, the independent auditors prepared separate annual financial statements for the Projects and the partnerships. Tr. 186-87. Ms. Mitrovitch acknowledged that there is no HUD Handbook provision or other guidance on segregation of partnership and project activity on the financial statements. Tr. 595, 615. According to Ms. Mitrovitch, segregation using separate columns, for example, is not the norm, but when it is employed, it makes the HUD reviewer's job "easier." Tr. 589-90.

> (a) Convey, transfer, or encumber any of the mortgaged property, or permit the conveyance, transfer or encumbrance of such property;
>
> (b) Assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out of any funds, other than from surplus cash, except for reasonable operating expenses and necessary repairs;
>
> * * *
>
> (i) Incur any liability, direct or contingent, other than for current operating expenses, exclusive of the indebtedness secured by the mortgage and necessarily incident to the execution and delivery thereof. . . .

AR-4A through AR-4C, AR4-E through AR4-F, ¶¶ 6(a), 6(b), 6(i). The Regulatory Agreement for Perry House contains identical provisions regarding conveyance and assignment, but provides that the owner must have prior written approval to "incur any liability or obligation not in connection with the project." AR-4D, ¶¶ 8(f).

77. The Partnership Agreements require that the general partners cause to be loaned or loan to the limited partnership "such funds as may be necessary to meet operating deficits," up to a specified maximum and within a specified timeframe, "so that the [limited partnership] does not default in payment of the mortgage note or with respect to any of its other obligations." PA-PM, PA-RA, ¶ 12(b); PA-VV, PA-JH, PA-EH, ¶ 6(b); PA-PH, ¶ 6.10. *See also* Tr. 156-57. The Partnership Agreements also require the general partners to advance or cause to be advanced to the partnerships funds needed to complete construction where initial capital contributions or other sources of funding are insufficient. PA-PM, PA-RA, ¶ 12(a)(ii); PA-VV, PA-JH, PA-EH, ¶ 6(a); PA-PH, ¶ 6.9.

78. The Regulatory Agreements do not include a definition of "reasonable operating expenses." Generally, operating expenses are understood to be those items related to the ongoing operation of the project. Payment of development fees and construction costs are not operating expenses. Tr. 109, 111, 961.

79. The Regulatory Agreements define a "distribution" as:

> Any withdrawal or taking of cash or any assets of the project, including the segregation of cash or assets for subsequent withdrawal within the limitations of Paragraph 6(e) [8(e) for AR-4D (Perry House)] hereof, and excluding payment for reasonable expenses incident to the operation and maintenance of the project.

AR-4A through AR-4C, AR-4E through AR-4F, ¶ 13(j); AR-4D, ¶ 16(h).

80. The Regulatory Agreements for all the Projects, except Perry House, provide that the limited partnerships cannot, without the Federal Housing Commissioner's prior written approval,

> Make, or receive and retain, any distribution of assets or any income of any kind of the project, except from surplus cash and except on the following conditions:
>
> (1) All distributions shall be made only as of or after the end of a semiannual or annual fiscal period, and only as permitted by the law of the applicable jurisdiction; all such distributions in any one fiscal year shall be limited to six per centum on the initial equity investment, as determined by the Commissioner; and the right to such distribution shall be cumulative;
>
> (2) No distribution shall be made from borrowed funds or prior to completion of the project or when there is any default under this Agreement or under the note or mortgage;
>
> (3) Any distribution of any funds of the project, which the party receiving such funds is not entitled to retain hereunder, shall be held in trust separate and apart from any other funds;
> (4) There shall have been compliance with all outstanding notices of requirements for proper maintenance of the project.

AR-4A through AR-4C, AR-4E through AR-4F, ¶ 6(e). The Regulatory Agreement for Perry House contains identical provisions, except that the provision limiting distributions in any one fiscal year to six percent on the initial equity investment is deleted. AR-4D, ¶ 8(e). The Housing Assistance Payments ("HAP") contract for Perry House sets forth the applicable annual distribution for that project. Tr. 462-63.

81. The Regulatory Agreements for all the Projects, except Perry House, define "surplus cash" as

> [A]ny cash remaining after:
>
> (1) the payment of:
>
> (i) All sums due or currently required to be paid under the terms of any mortgage or note insured or held by the Federal Housing Commissioner;

(ii) All amounts required to be deposited in the reserve fund for replacements;

(iii) All obligations of the project other than the mortgage insured or held by the Commissioner unless funds for payment are set aside or deferment of payment has been approved by the Commissioner;

(iv) Remittances due to the Commissioner as required by paragraph 4(i); and

(2) the segregation of:

(i) An amount equal to the aggregate of all special funds required to be maintained by the project;

(ii) All tenant security deposits held;

(iii) That portion of rentals which must be remitted to the Commissioner in accordance with Paragraph 4(i), but not yet due.

AR-4A through AR-4C, AR-4E through AR-4F, ¶ 13(g). The definition of "surplus cash" in the Regulatory Agreement for Perry House is nearly identical, except that it begins with the phrase "any cash remaining at the end of a semiannual and annual fiscal period," and omits the provisions designated as (1)(iv) and (2)(iii) in the other Regulatory Agreements. AR-4D, ¶ 16(f).

82. Prior to 1992, project owners were not required to obtain prior HUD approval to make or repay operating advances, if, at the time the loan was made, an operating deficit existed, and if, at the time the loan was repaid, the repayment were not cause mortgage delinquency or default, or financial hardship. Also, prior to 1992 and without prior HUD approval, owner advances could be repaid out of either surplus cash or the project's operating account, as long as the repayment was otherwise permissible.[63] Tr. 119-20, 142, 66, 295, 523, 533-34, 536-37, 609-10, 630, 962, 1277.

83. The Audit Guide for Mortgagors Having HUD Insured or Secretary Held Multifamily Mortgages, IG 4372.1 (June 1978), a HUD Handbook issued by HUD's Office of Inspector General for use by IPAs provided:

[63]It has always been a requirement that money advanced to pay development fees not be paid from project funds. Tr. 961-62.

> Necessary and Reasonable Expenses.
>
> There are no precise definitions of expenses necessary and reasonable to the operation and maintenance of the project, and the IPA will have to make a judgment as to the propriety of project disbursements. . . .Withdrawals of project funds to reimburse owners for prior advances, capital expenditures and project acquisition costs do not constitute payment of expenses necessary and reasonable to the operation and maintenance of the project while the mortgage is in default, under modification, forbearance or under provisional work-out arrangements, unless the owner has prior written approval from HUD.

R-11, ¶ 8(d). *See also* Tr. 1069, 1126-28, 1132, 1182-83. The HUD Handbook concerning Financial Operations and Accounting Procedures for Insured Multifamily Projects in effect from April 1974 to April 1981 did not contain specific guidance concerning the repayment of owner advances. The Handbook provided, however, that distributions did not include "cash advances made after final endorsement to meet reasonable operating and maintenance expenses." AR-3 (HUD Handbook 4371.1, ¶ 8(b)(1) (Apr. 1974)). The Handbook in effect beginning in April 1981 included the following provisions, under the heading "Repayment of Owner Advances":

> a. Authorized repayments of advances made for necessary and reasonable operating expenses are not considered distributions and, hence, are not subject to the surplus cash rules set forth in the project regulatory agreement and in Paragraph 7 above.
>
> b. If the project is current under the mortgage, advances made for reasonable and necessary operating expenses may be paid from project income without HUD approval. Project management, however, must exercise prudent judgment as to the timing of the repayment. Advances should not be repaid when the repayment would cause delinquency or default under the mortgage or impose a financial hardship on the project.
>
> c. If the project is delinquent under the mortgage, loans and advances made by the owner to meet necessary and reasonable operating expenses may not be repaid from project income unless written approval has been given by HUD. Requests for repayment of advances or loans from project income while the mortgage is in default will generally be considered only if the project is under a workout agreement and is current in the payments required under that agreement.

NP-6 (HUD Handbook 4370.2, ¶ 8 (Apr. 1981)); *see also* Tr. 607-10.

84. Beginning in 1992, owners were required to obtain HUD approval prior to

making any operating advances, and repayments of such advances were classified as distributions which could only be made out of surplus cash. Tr. 533, 962.[64]

[64]The direct testimony of Ms. Mitrovitch, on the need for approval to make or repay operating advances was elicited and given in such a way that was misleading. Until cross-examination put a time frame on her testimony, the natural inference from her direct testimony was that HUD had *always* required its prior approval to make or repay an operating advance. This testimony undermines not only Ms. Mitrovitch's credibility, but the posture taken by Government Counsel in this proceeding. *See, e.g.*, Tr. 489-90, 493-95, 522-23, 533, 606, 609-10.

85. The Regulatory Agreements for all the Projects except Perry House require that the limited partnerships establish and maintain a "reserve fund for replacements" and a "residual receipts fund."[65] Disbursements from the reserve fund for replacements "whether for the purpose of effecting replacement of structural elements and mechanical equipment of the project or for any other purpose, may be made only after receiving the consent in writing of the Commissioner." Disbursements from the residual receipts fund can be made only on HUD's direction. HUD has "the power and authority to direct that the residual receipts, or any part thereof, be used for such purpose as [it] may determine." The Regulatory Agreement for Perry House requires that the limited partnership establish and maintain a "reserve fund for replacements." The provision requiring the establishment and maintenance of a "residual receipts fund" is stricken. AR-4A through AR-4F, ¶¶ 2(a), 2(c). *See also* Tr. 499-504.

86. The Partnership Agreements require that capital contributions made to the limited partnerships be used to pay, *inter alia*, development fees to CHRC, or in the case of Perry House, to HRC. PA-PM, PA-RA, ¶ 9(f); PA-VV, PA-JH, PA-EH, ¶ 5(c); PA-PH, ¶ 6.11.

87. Some of the Projects, from their inception in the early to mid-1970s, experienced operating deficits that had to be covered. During those years, the Projects' income streams, based upon rent proceeds, were generally insufficient to support operating expenses, particularly given the inflation and high energy costs that existed at the time.[66] Given the restrictions set forth in the Projects' Regulatory Agreements pertaining to encumbering the properties and to the sources of loan repayment, obtaining loans from commercial lending institutions was not deemed feasible. CHRC

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[65]"Residual receipts" means any cash remaining after deducting "distributions" from "surplus cash." *See, e.g.,* AR-4A, ¶ 13(h).

[66]Contrary to the position taken by the government, the annual audited financial statements for Valley Vista support Mr. Weitz' testimony that high energy costs during the mid-1970s contributed to operating deficits. *See* Tr. 74-81. During the period covered by the 1974, 1975, and 1976 statements, electricity costs constituted, respectively, 37% , 48%, and 36% of net rental income. In 1974 and 1976, combined electricity and mortgage related costs constituted in excess of 80% of net rental income. In 1975, those combined costs exceeded net rental income. *See* JE-VV 1974 at 6, 11; JE-VV 1975 at 6, 11; JE-VV 1976 at 7, 12.

and HRC were considered to be the "lenders of last resort." Mr. Weitz did not obtain, nor did he believe it was necessary to obtain, HUD's prior approval before advances by the General Partners, CHRC and HRC, to the Projects were made. When the advances were made, CHRC and HRC expected that the advances would be repaid from any funds that were available, including surplus cash. Tr. 42, 58-61, 64-68, 141-44. *See also* Tr. 293-94.

88. In preparing the financial statements for the Projects,[67] the IPAs started with the limited partnerships' general ledger for the prior year. The IPAs would then create a trial balance from the general ledger balance. Next, they would review transactions that had occurred, pursuant to their standard audit programs. The review would include an examination of invoices, receipts, checks, and bank statements; confirmation with the mortgagee that debt service had been paid; and performance of lease tests. The IPAs would then make adjusting journal entries ("AJEs") to the trial balance to fairly reflect the economics and reality of the transactions that had occurred and the partnerships' financial condition. At the end of the audit, the trial balance would be closed, and the financial statements would be drafted. Preparation of the financial statements involved IPA staff, managers, partners, and, ultimately, the IPA review department or the partner responsible for review. Mr. Weitz would review the financial statements, and unless a glaring error existed, he accepted them. Tr. 46-48, 72-74, 111-14, 119, 160-61, 956-59, 973-74, 996, 999-1002, 1063-67, 1070-74, 1078-81, 1118-1126, 1134-35, 1207-10.

89. In the initial years of the Projects, the partners of the limited partnerships made capital contributions both before and after cost cut-off, *i.e.*, a date up to 60 days after substantial completion of a Project. On the limited partnerships' original books of entry, capital contributions and advances of funds would be booked to a single partnership account. The capital contributions were used to pay fees to the General Partners, to meet cash equity requirements, to pay syndication costs, to cover cost overruns, and to pay legal, organizational and auditing costs. The advances of funds were required to complete construction, to meet operating deficits, or otherwise to be necessary in the judgment of the General Partners. The account was usually designated as "due to/from General Partner related entity."[68] As the Project needed

[67] From 1972 until 1986, three firms successively prepared the financial statements concerning the Projects at issue: Zigger, Resnick and Fedder; Alexander Grant and Company; and Resnick, Fedder and Silverman. During that period, the audits were chiefly conducted by and/or under the supervision of David Resnick and/or William D. Riley, Jr. In 1986, the firm of Freedman and Fuller was retained, with Kathleen Flaherty ultimately serving as the manager involved in auditing the Projects. Freedman and Fuller conducted the audits until 1990, when the firm of Miller and Benz (later Benz, Flaherty and Kreber) was retained. At the time Miller and Benz was retained, Ms. Flaherty had already left Freedman and Fuller and had joined Miller and Benz as a shareholder. To date, Ms. Flaherty is the person primarily responsible for auditing the Projects. Tr. 43-45, 173-78, 180-87, 947, 951-58, 998-99, 1055, 1057, 1060-64, 1071-72.

[68] Although styled "operating loan advances," AR-33 is Ms. Flaherty's analysis of the "due to/from General Partner related entity" account that she prepared in connection with audit resolution. Thus, despite its inexact title, it includes *both* actual operating advances and capital contributions.

funds, money from the account would be disbursed. At the end of the year in which operations began or during the following year when the IPAs were conducting their audits, they would ascertain the Project's net losses *on a cash basis*[69] from the Project's operating statement, and then allocate a corresponding portion of the single partnership account as operating loss advances.[70] The remaining portions of the funds would be allocated as payment of development fees, construction costs, or other liabilities.[71] The IPA then used AJEs, referred to as "reclassifications," to reflect this apportionment process between accounts on the ledgers and to record the details in the workpapers. AJEs also rectified errors made in transferring amounts from original books of entry to the general ledger. *See, e.g.*, Tr. 46-47, 73-74, 111-12, 162-65, 221-22, 236-37, 265-67, 974-75, 978-81, 996, 1004-05, 1086-87, 1089-95, 1102-14, 1152-59, 1162-76, 1185-88, JE-EH 1975; JE-EH 1976; JE-PM 75; JE-PM 1976; JE-PM 1977; JE-PM 1978; R-12; AR-8; AR-13; AR-14; AR-15; AR-16; AR-18; AR-21; AR-23.

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[69]The accounting for the Projects was done on an accrual basis; however, the financial statements were prepared on a cash basis when the IPAs reviewed the books of the Projects at the end of the year. Tr. 161.

[70]Where the annual financial report was prepared before all allocations could be made, the balance sheet showed a liability, among others, designated "general partner related entity." That liability included both operating and development advances. Once the allocation could be made, the following year's balance sheet separated out from that account the amount that covered actual operating losses. On the statement of receipts and disbursements, the top half would show the extent of any operating loss (excess of disbursements over receipts from operations); the bottom half would show partnership (as opposed to project) receipts and disbursements. On the bottom half, the term "operating loan advances" is loosely, if not erroneously, used to describe a category of disbursements for development. It is actually the non-operating portion of the unsegregated category on the previous year's balance sheet designated "general partner related entity." *See, e.g.*, JE-PM 1975; JE-PM 1976; JE-EH 1975; JE-EH 1976.

[71]The first financial statement for the period following cost cut-off shows the initial dichotomy between the construction and development period on the one hand, and the beginning of the operating period, on the other. Tr. 113.

90. Development fees owed to CHRC (and HRC) were paid from nonproject funds including construction loan draws and capital contributions. When the payments of such funds were booked as development fees paid to CHRC (and HRC), the funds were not necessarily actually paid out into separate accounts for CHRC (and HRC). In some cases, they were used to fund operating advances to the Projects by CHRC (and HRC), and when so used, were merely rebooked on the Projects' accounts as operating advances, with the account for development fees debited accordingly. This accounting

process eliminated the need for issuing two sets of checks to evidence the payment of a development fee out and the payment of an advance in. Tr. 978, 1087-89.

91. Except with regard to some initial transactions, the limited partnerships did not execute promissory notes to evidence advances by CHRC (and HRC) to cover operating expenses. The transactions were treated as a line of credit. Tr. 102, 115, 165.[72] *See also* Tr. 1021.

92. Accrual of interest on the amounts shown as operating advances, to be paid by the Projects, was set forth either in footnotes to the financial statements or on the balance sheets.[73] Tr. 116-17, 119, 123-29.

[72]Mr. Weitz testified that he was unable to locate any promissory notes, but believed that some had been executed early on. In his opinion, he was not, in any event, obligated to keep them beyond six or seven years. He further testified that as the number of loan transactions increased, it became impractical to continue to issue notes. Tr. 102-03. *See also* Tr. 165.

[73]The Government's allegations concerning the impropriety of accruing and paying interest on the funds earmarked as owner advances arose during the hearing and were not contained in the Amended Complaint. Therefore, they are not properly made a subject of this proceeding. However, in light of the testimony on the interest issue that was elicited at the hearing, I have concluded that the allegations are meritless, since the weight of evidence shows that HUD has neither expressly authorized nor prohibited the accrual and payment of interest on owner advances. *See, e.g.*, Tr. 972, 1021-22, 1381, 1431-32. Indeed, I reach this conclusion despite Ms. Mitrovitch's testimony that a HUD Handbook provision prohibited the accrual and payment of such interest. That assertion further seriously undermined her credibility because while she expressly represented that such authority existed and that she would provide it for the record, she failed to do so. Tr. 497-98, 523-27, 563.

93. The partners of the limited partnerships invested in the Projects primarily as tax shelters.[74] In the early 1980s, the Projects began to show a relatively consistent positive cash flow. No limited dividend distributions were paid. In some instances, operating advances were repaid with Project cash, and in at least one case, with the proceeds of a Section 223(d) Operating Loss Loan.[75] In other instances, surplus cash which otherwise could have been used to repay the operating advances was left with the Projects in reserve accounts.[76] The accounts were different from the Projects' reserve fund for replacements. They were "rainy day" funds, intended to provide a source of funds for any repairs or improvements beyond those covered by the reserve fund for replacements.[77] They were also intended to obviate the need for additional contributions from the General Partners who, at the time, were seeking repayment of prior advances and resisting any request for further infusions of cash.[78] Mr. Weitz did not obtain HUD's prior approval, nor did he deem such prior approval necessary, in establishing the reserve accounts.[79] *See, e.g.*, Tr. 128, 130-33, 154-59; JE-PM 1978;

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[74]When the tax laws were changed in 1986 so that passive losses were no longer fully deductible, the limited partnerships lost their attractiveness as tax shelters. *See, e.g.*, Tr. 627-28.

[75]Particularized facts related to the Operating Loss Loan are set forth *infra* under Count II.

[76]Despite the fact that the Government has previously represented that surplus cash is not an issue in this case, the Government asserts in its Post-Hearing Brief that HUD's surplus cash rules were violated when certain operating advances were repaid. *See, e.g.*, Transcript of Jan. 10, 1994, Pre-Hearing Conference at 10; Government's Post-Hearing Brief, Proposed Finding of Fact No. 18. In order to put this issue to rest, I find that insofar as operating advances were repaid with either partnership funds or project cash, the repayments being questioned by the Government were booked prior to 1992 when such advances could be repaid from either source, regardless of surplus cash. *See* JE-PM 1975; JE-PM 1976; JE-PM 1977; JE-PM 1978; JE-PM 1980, JE-PM 1991; JE-EH 1976; JE-EH 1977; JE-EH 1981; JE-EH 1987; JE-RA 1976; JE-RA 1977.

[77]By Motion filed on August 1, 1994, the Government seeks to strike a post-hearing exhibit attached to Respondents' Reply Brief. That exhibit, labeled by Respondents as "Schedule A," purports to be a project-by-project analysis of interest income earned from 1974 through 1990. *See* Reply to Government's Post Hearing Brief at 34-35 n. 31, *citing* Tr. 117-18. The Government argues that it does not know who prepared the exhibit, that it had no opportunity to cross-examine the preparer, and that it has no way of testing the conclusions reached. *See* Government's Motion to Strike (Aug. 1, 1994). In opposition, Respondents represent that the exhibit is merely an extraction of data obtained from the previously admitted financial statements. *See* Response to Government's Motion to Strike (Aug. 8, 1994).

Given the absence of any demonstration that the schedule does not accurately reflect what Respondents have claimed, the Government's Motion to Strike is hereby denied. That schedule shows that the Projects earned an aggregate of $638,436 in interest on the undistributed funds kept in the "rainy day" accounts.

[78]The establishment of the reserve accounts was consistent with Mr. Weitz' philosophy that to provide quality housing and to achieve long-term profits in addition to short-term tax benefits, the Projects had to be well maintained. Tr. 158-59.

[79]Ms. Mitrovitch acknowledged that there is no HUD requirement that a project owner obtain prior

R-19; JE-EH 1987.

94. Funds for repairs at some of the Projects, including Valley Vista were withdrawn from the reserve accounts.[80] The reserve accounts were closed in early 1990, after the Baltimore, Washington and Richmond field offices rejected rent increase applications for the Projects in light of the funds that had accumulated in the accounts. At that time, the funds were withdrawn from five of the six Project's reserve accounts,[81] and operating advances, with accrued interest, were repaid.[82] Mr. Weitz did not obtain, nor did he believe it was necessary to obtain, HUD's prior approval before repaying the advances with interest. Tr. 128-29, 131-38, 142, 154-55. *See also* Tr. 968-69.

Count II: The Alleged Improper Procurement and Use of an Operating Loss Loan

95. Paragraph 6(e)(2) of the Pemberton Manor Regulatory Agreement states that, in the absence of the prior written approval of the Commissioner, "[n]o distribution shall be made from borrowed funds . . . ." AR-4A, ¶ 6(e)(2).

96. At all relevant times, Section 223(d) of the National Housing Act provided as follows:

> With respect to any mortgage, other than a mortgage covering a one- to four-family structure, heretofore or hereafter insured by the Secretary, and notwithstanding any other provision of this chapter, when the taxes, interest on the mortgage debt, mortgage

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approval before placing distributable surplus cash into a segregated partnership account, although "it would be in his best interests to come to us before he does this." Tr. 593-95.

[80]Contrary to the Government's assertion that no reserve account funds were expended to make repairs at Valley Vista, the record indicates that such repairs were made. *See* JE-VV 1988 at 2; JE-VV 1989 at 2, 15.

[81]The advances related to Pemberton Manor were not repaid and still exist on the books because the Baltimore office issued a directive that no more distributions of surplus cash be made. Tr. 137, 139-41.

[82]The repayments did not exceed the amount of surplus cash available. Tr. 169.

> insurance premiums, hazard insurance premiums, and the expense of maintenance and operation of the project covered by such mortgage during the first two years following the date of completion of the project, as determined by the Secretary, exceed the project income, the Secretary may, in his discretion and upon such terms and conditions as he may prescribe, insure under the same section as the original mortgage a loan by the mortgagee in an amount not exceeding the excess of the foregoing expenses over the project income.

12 U.S.C. § 1715n(d) (1982).[83] *See also* Tr. 1182-83.

97. HUD Handbook, RHM 4350.1 Supp. 1 (Sept. 1970), provides:

> 1. TWO YEAR OPERATING LOSS.
>
> a. Under the provisions of Section 223(d) of the National Housing Act as amended, the insurance of a supplemental loan is authorized to cover the loss experienced by a mortgagor during the first two (2) years of operation following the date of completion of the multifamily project. Such recoupment is limited to the amount by which disbursements for taxes, interest, mortgage insurance premiums, property insurance premiums, and expenses for maintenance and operation (exclusive of all capital improvements) exceed the income of the property.

R-26 (RHM 4350.1 Supp. 1, Ch. 4, § 16, ¶ (1)(a) (Sept. 1970)).

98. By letter dated March 21, 1977, and signed by Mr. Weitz, CHRC applied to HUD for an "Operation [sic] Loss Loan" for Pemberton Manor in the amount of $580,500.00, "to be insured pursuant to the provisions of Section 223(d) and Section 236 of the National Housing Act, as amended." OLL-2 at 1. The letter, sent to Everett H. Rothschild, Director of HUD's Baltimore Area Office, stated:

> The requested Operation [sic] Loss Loan in the amount of $580,500 will be used to bring the mortgage current and reinstate the loan, to pay additional legal and accounting fees, and to establish an escrow fund of $250,000 for the correction of construction deficiencies. The balance of loan proceeds will be used to meet any future operating deficits. No loan proceeds will be used for repayment of funds advanced to the project by the

[83] Section 223(d) as set forth above is the statutory provision as it existed prior to amendment in 1988. The statutory language cited in the Government's Post-Hearing Brief is the provision as amended in 1988. The Section 223(d) program has rarely been used, and a separate HUD program, Section 241, exists to insure loans for the improvement of HUD assisted properties. *See* Respondents' Post-Hearing Brief at 28-29 n.65; Tr. 1182-83.

Owner.

Id. at 5. Roof deficiencies were among the construction defects to be corrected using the escrow fund.[84] *Id*. *See also* Tr. 1540, 1544-45, 1571-72, 1623.

[84]As detailed *infra*, Count IV of the Government's Amended Complaint includes specific allegations concerning the correction of roof defects.

99. J.F. Cronk, Director of the Baltimore Area Office Housing Development Division,[85] advised Mr. Weitz that the $250,000 item set forth in the March 21, 1977, letter was not allowed under the Section 223(d) program, and suggested that Mr. Weitz file another application without the item.[86] Accordingly, by letter dated April 29, 1977, and signed by Mr. Weitz, CHRC made a "formal request for an 'Operation Loss Loan' in the amount of $329,638.00, to be insured pursuant to the provisions of Section 223(d) and Section 236 of the National Housing Act, as amended." The letter, sent to Mr. Rothschild, stated that the loan was "necessary to liquidate an operational deficit and prevent possible foreclosure." Included with the loan application were three audited financial statements: one for the period commencing with cost cut-off (October 23, 1975) and ending on December 31, 1975, one for calendar year 1976, and one for January and February, 1977.[87] The financial statement for the period ending December 31, 1975, showed that Pemberton Manor suffered a loss of $108,918. Backing out depreciation of $70,787, the loss for that period was $38,131. The financial statement for calendar year 1976 showed that Pemberton Manor suffered a loss of $672,331. Backing out depreciation of $359,159 and the payment for a covenant not to compete in the amount of $50,000, the loss for that period was $263,172. The financial statement for the two months ending February 28, 1977,[88] showed that Pemberton Manor suffered

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[85]Although Mr. Cronk was listed by the Government as a potential witness regarding the OLL, he was not called to testify at the hearing. Moreover, the Government also listed, but did not call James Tahash, Director of HUD Headquarters' Planning and Procedures Division, Office of Multifamily Housing Management. Mr. Tahash was to have testified "as to statutory, regulatory and program requirements concerning limited distribution motgagors, and requirements concerning operating loss loans." *See* Government's List of Witnesses (March 15, 1994).

[86]Mr. Weitz testified that even after the $250,000 request was rejected by HUD, conversations with officials in the Baltimore Office continued for a period of six to seven months in an attempt to find some source for the requested funds. Tr. 1572-73.

[87]In connection with Count II, the Government takes issue with two reclassifications: a 1977 reclassification of a $108,736.38 payment of operating advances into a payment of development fees (AR-22 at 1-2), and a 1978 reclassification of $268,378.00 of unpaid development fees into operating advances (OLL-17; OLL-18; OLL-19). According to the Government, the reclassifications demonstrate that Mr. Weitz obtained the OLL and applied its proceeds under false pretenses by artificially inflating the amount of operating advances payable. Respondents on the other hand assert and present evidence that both reclassifications were made to reflect the proper allocation of capital contributions between development fees and operating advances. Based on a review of the record, which does not contain a complete set of workpapers for these 17 year old AJEs, I cannot conclude that the Government has shown the reclassifications to have been improper. *See, e.g.*, Tr. 207-13, 221-22, 265-67, 1101-12, 1162-76, 1234-36; OLL-17, OLL-18; OLL-19; R-13; R-14; AR-13; AR-18; AR-22; AR-23; JE-PM 1975; JE-PM 1976; JE-PM 1977.

[88]Despite Mr. Ward's testimony to the contrary, this financial statement was an *audited* financial statement. As explained by Ms. Flaherty and unbeknown to Mr. Ward, pursuant to Generally Accepted Auditing Principles applicable at the time the statement was prepared, inclusion of the phrase "we have examined" indicated that the statement was audited. Tr. 647-48, 1206-07; JE-PM Feb. 1977.

a loss of $28,335.[89] The total of $38,131, $263,172 and $28,335 is $329,638, the amount applied for by Respondent. OLL-3; JE-PM 1975; JE-PM 1976; AR-22; Tr. 638-41, 1540-41, 1623. *See also* R-13.

100. By letter dated May 12, 1977, Mr. Cronk requested that Mercantile Mortgage Corporation ("Mercantile"), the mortgagee for the Operating Loss Loan, submit specified information to HUD so that it could begin to process the Operating Loss Loan application. The letter did not mention the use to which the loan proceeds would be put. R-27. *See also* Tr. 1542.

[89]The Auditor's Report accompanying the December 1976 and February 1977 financial statements stated:

> The Partnership has experienced a significant cash loss from operations during the period principally due to high operating expenses, and has other liabilities in excess of cash and accounts receivable at [December 31, 1976 and February 28, 1977, respectively]....In addition, as negative cash flow positions arise it will be necessary to continue to receive operating loan advances or obtain additional invested capital.

JE-PM 1976; AR-22.

101. By letter dated November 28, 1977, and signed by Patricia M. Berg, President of CMC,[90] CMC applied to the Federal National Mortgage Association ("FNMA") for a modification of the mortgage for Pemberton Manor for calendar year 1978. One "major reason" cited for the mortgage modification request was "[c]onstruction deficiencies which adversely impact operating costs." The request, sent to Esther O. Walder of FNMA,[91] stated that:

> On March 21, 1977, the Owner made a formal request for a HUD Operation Loss Loan pursuant to Section 223(d) of the National Housing Act. This loan request is presently being processed by the Baltimore Area Office of HUD. If approved and funded, we understand that the Owner will use all or part of the proceeds to correct deficiencies at the project.

CMC provided Mr. Rothschild and Mr. Weitz with copies of the mortgage modification application. OLL-4; OLL-5.

102. On December 7, 1977, representatives of "the mortgagor" and HUD met at the offices of FNMA to discuss CMC's request for the mortgage modification. The resulting FNMA Report recommended "[a]pproval of a 12-month deferment of principal effective 1/1/78 provided the Operating Loss Loan is granted and a portion of the proceeds allocated to repairs required at the project." The FNMA Report also stated in the block marked "Mortgagor's Proposed Contribution to Cure Delinquencies," that "[i]f approved, will use Operating Loss Loan proceeds to make needed repairs and pay costs incurred by construction defects. Will request Sec. 8 and increase in RAP by 20%." OLL-6.

103. By letter dated December 12, 1977, from Ms. Berg to Ms. Walder, Ms. Berg set forth her understanding of a meeting that had been attended by representatives of CMC, HUD and FNMA. Ms. Berg stated that her understanding was that FNMA approval of a modification of the Pemberton Manor mortgage was conditioned upon HUD's approval of an Operating Loss Loan. The letter further stated Ms. Berg's understanding that Mr. Weitz would agree to use the loan proceeds "to cure the

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[90] Although Ms. Berg was listed by the Government as a potential witness concerning the OLL, she was not called to testify at the hearing. *See* Government's List of Witnesses (March 15, 1994).

[91] Although Ms. Walder was listed by the Government as a potential witness concerning the mortgage modification and the OLL, she was not called to testify at the hearing. *See* Government's List of Witnesses (March 15, 1994).

documented construction deficiencies, especially those deficiencies which adversely impact operating costs both current and future (*i.e.*, poorly constructed floors, inadequate structural components, and deficient window installation)." OLL-7.

104. By letter dated December 16, 1977, Ms. Walder responded to Ms. Berg's letter. Ms. Walder stated that she agreed with Ms. Berg's statement of the conclusions reached at the meeting. However, she stated that she could not agree to Ms. Berg's request that the Modification Agreement be prepared and held in abeyance prior to the approval of the Operating Loss Loan. In so declining, Ms. Walder stated that in FNMA's "opinion, the success of the entire plan depends on the Operating Loss Loan, [and] we have made it a condition to the approval of the deferment." OLL-8.

105. By letter dated January 31, 1978, Ms. Walder advised Mr. Rothschild that Pemberton Manor's request to apply to HUD for an Operating Loss Loan had been approved. Ms. Walder requested that HUD formally approve deferment of the mortgage payments, and that HUD advise FNMA of its approval of the operating loss loan. OLL-9.

106. By memorandum dated February 3, 1978, Robert G. Heacock of the HUD Baltimore Office Housing Management Division recommended to Mr. Rothschild that mortgage modification be granted. "Construction deficiencies" were among the "major reasons" cited for the modification request. The memorandum further stated:

> The mortgagors have requested an Operating Loss Loan in the amount of $329,600. They intend to use the proceeds to complete the repairs necessary to correct construction deficiencies and cover excess operating expenses these deficiencies have caused. The mortgagors filed a suit in August 1976 against the contractor. We do not know, at this time, whether the suit will be successful.
>
> Housing Development has informed us they are currently processing the Operating Loss Loan, which we hope will be finalized within the next several months. The loan will be subject to the agreed conditions whereby the owners, if successful in their suit, will apply the funds (net litigation expenses) to prepay the Operating Loss Loan.

OLL-10.

107. By memorandum dated February 9, 1978, Mr. Heacock advised Mr. Cronk that the Housing Management Division had approved the request for an Operating Loss Loan. Mr. Heacock also expressed the Housing Management Division's concurrence with Housing Development's view that "the final approval of the Operating Loss Loan will be subject to the agreed condition whereby the owner, if successful in his lawsuit

against the contractor, will apply the funds, less litigation expenses, to prepay the Operating Loss Loan." OLL-12.

108. On March 16, 1978,[92] Mr. Weitz, Pemberton Manor's Trustee, and Ms. Walder executed the mortgage Modification Agreement for Pemberton Manor, retroactive to January 1, 1978. The Agreement was approved by Mr. Rothschild on behalf of the Secretary. The Agreement did not mention the OLL OLL-13.

109. On August 9, 1978, HUD issued its Commitment to Insure a Section 223(d) Operating Loss Loan, with Pemberton Manor as the Mortgagor and Mercantile as the Mortgagee. Based on HUD's own calculations and analysis, the commitment was issued in the amount of $292,500. The Commitment sets forth 15 conditions imposed by HUD. However, none of those conditions speaks to repair of any construction defects. Moreover, it concludes:

> This commitment and exhibits referred to herein together with the applicable Federal Housing Administration regulations constitute the entire agreement between us, and acceptance of the terms hereof is evidenced by the signature and seals of the Mortgagor and Mortgagee upon the lines provided below.

R-28. *See also* Tr. 1541, 1543-44.

110. The applicable regulation, 24 C.F.R. § 221.509(a)(3) states that "[t]he issuance of a firm commitment evidences the Commissioner's approval of the application for insurance and sets forth the terms and conditions upon which the mortgage will be insured."

111. By letter dated October 26, 1978, Mercantile issued its firm commitment letter to loan the $292,500. The letter makes no reference to repair of construction defects and states:

> FHA Mortgage Insurance
> Any requirements of the Federal Housing Administration during the life of the loan, are incorporated herein by reference as a condition to this commitment.

R-29. *See also* Tr. 1544.

[92]The parties to the Modification Agreement signed on different dates. The last party to sign did so on March 16, 1978. OLL-13.

112. Representatives from HUD were present at the loan closing. No such representative made any statement that the loan proceeds were to be used to repair roof defects. Tr. 1573.

113. On December 6, 1978, Mercantile issued two checks totalling $266,637.50 and made payable to Pemberton Manor Associates. Respondent Weitz endorsed these checks as follows: "Pay To The Order Of Community Housing & Research Corporation . . . For Deposit Only To The Account Of Community Housing & Research Corporation In Bank of Columbia, N.A. 0055875." The endorsement of the check to CHRC constituted repayment of operating advances that had been made by CHRC.[93] The Operating Loss Loan proceeds used to repay the advances were non-project funds. OLL-1; OLL-20; OLL-21; R-14; Tr. 1109, 1112, 1176-80, 1182, 1189-94, 1539-40.

114. The audited annual financial statement for Pemberton Manor for the period ending December 31, 1978, showed that the Operating Loss Loan was a source of cash and that cash had been used to repay operating loan advances. The financial statement did not indicate that cash had been used for the repair of construction defects. Note B(1) to the financial statement stated that the mortgage was under modification. Note B(2) stated that FHA had insured an operating loss loan. The Note describes the terms of the loan, and makes no mention of the use to which the proceeds were put. JE-PM 1978; OLL-14; Tr. 1131-32.

115. The first time any questions were raised by HUD with Mr. Weitz concerning the use to which the OLL proceeds had been put was during the July 8, 1993, meeting between Mr. Weitz, Ms. Flaherty, Mr. Ward and Ms. Bullock. OLL-16; Tr. 1225-27, 1234, 1244, 1248-49, 1582, 1599-1602.

Count III: The Alleged Improper Payment of a $212,033 Note Payable

[93] A journal entry for Pemberton Manor prepared in the first quarter of calendar year 1979 states that the $266,637.50 net proceeds of the OLL was assigned "to pay balance of Development fees and Operating Advances of CHRC." OLL-1. At the time, however, no outstanding development fees were owed. *See* JE-PM 1977 at 6; JE-PM 1978 at 19. Moreover, the journal entry further states that the full amount of the proceeds was applied to repay CHRC for "'Operating Loans' advanced." OLL-1. Thus, the entry is consistent with a finding that the assignment of the OLL proceeds constituted payment only of operating advances that had been made by CHRC, and that the phrasing used in the entry represented a catchall category.

116. Paragraph 6(b) of the Regulatory Agreement for Essex House states:

> 6. Owners shall not without the prior written approval of the Commissioner:

> (b) . . . pay out any funds, other than from surplus cash, except for reasonable operating expenses and necessary repairs.

AR-4B, ¶ 6(b).

117. The payment of development fees and construction costs are not operating expenses. They are payable out of the capital accounts of the limited partners. Tr. 109-111, 994.

118. On the Statement of Assets and Liabilities in the 1983 annual audited financial statement (year-end September 30, 1983) for Reynolds Associates T/A Essex House, there is listed under the heading "long-term liabilities" a $212,032.54 "note payable - general partner." Note G to the financial statement refers to this note payable, and states that:

> The note to Community Housing and Research Corporation, the developer and a general partner related entity, for development fees is noninterest bearing and may not be paid from project funds until the mortgage is fully amortized. It may be paid out of current residual receipts, as defined by HUD, with the approval of the commissioner.

In the Supplemental Information section of the financial statement, under the heading "Loans and Notes Payable (Other than the Insured Mortgage), there is listed a non-interest bearing debt incurred in 1975, in the original amount of $644,144, owed to CHRC for development fees, with an amount due of $212,032. JE-EH-1983.

119. On the Balance Sheet in the 1989 annual audited financial statement (year-end September 30, 1989) for Reynolds Associates T/A Essex House, under the heading "Liabilities and Partners' Equity" and sub-heading "long-term liabilities" is a "Note payable, general partner" in the amount of $212,033. With regard to this note payable, the Balance Sheet refers to Note 6 that states:

> Note payable to general partner:
>
> A note payable to Community Housing and Research Corporation for the unpaid development fees is non-interest bearing and may be paid only after the mortgage is fully amortized or with the approval of HUD from distributable cash flow in excess of the 6% limited dividend.

In the Supplemental Information section of the financial statement, under the heading "Loans and notes payable (other than the insured mortgage)", reference is made to, *inter alia*, Note 6. JE-EH 1989.

120. In April of 1990, when the decision was made to close the reserve accounts

and to pay the operating advances, Mr. Weitz asked Arvind Shah of CMC to provide him with a list of operating advances that had been made on a project-by-project basis, with a breakdown of the outstanding loan balance, the accrued interest, and the accrued administrative fees payable to CHRC. Mr. Shah reported with regard to Essex House that the principal balance owed for "operating loans" was $212,033, the accrued interest was $5,932, and the accrued but unpaid administrative fees were $6,000.[94] Tr. 146-48, 151-52, 281.

121. On April 18, 1990, the $212,033 note payable and the accrued interest were paid.[95] The $217,965 total payment was made by CMC in the form of an account transfer from an Essex House project account to an account of CHRC. Both accounts were held at First Commercial Bank of Arlington, Virginia. The payment was shown on

[94]Mr. Weitz testified that he asked Mr. Shah to make certain that the total of the amounts listed did not exceed the amount of surplus cash. He made this request because although he did not believe that the amount of surplus cash limited the repayments, he did not want to be criticized as imprudent for making payments in excess of the amount of surplus cash. Tr. 147. *See also* Tr. 168-69. The 1989 financial statement for Essex House, when read in conjunction with the 1990 financial statement shows that there was, indeed, surplus cash in excess of $212,033. The Government is in error in suggesting that $49,498 should be subtracted from the previous year's surplus cash because it is automatically taken into account in the calculation of surplus cash distributable during the next fiscal period. JE-EH 1989 at 16. However, even after subtracting the $49,498 represented on the 1989 statement as a loan to a general partner, taking into consideration the prior period adjustment on the September 30, 1990, financial statement, $295,560 in surplus cash was available. JE-EH 1989 at 16; JE-EH 1990 at 13 n.9. Accordingly, although surplus cash is not an issue in this case, I note that the Government, in relying solely on the 1989 statement, inaccurately represents that only $176,570 of surplus cash was available when the note was paid. *See* Government's Post Hearing Brief, Proposed Finding of Fact No. 40.

[95]Respondent Weitz and Ms. Flaherty believed that the erroneous payment was based on Mr. Shah's incomplete reading of the financial statements. Mr. Shah was not called by either party to testify at the hearing. *See* Tr. 147, 150-53, 281.

the general ledger as payment of the note payable - general partner. Tr. 147-48, 152, 281; NP-2; JE-EH-1990 at 7, 11.

122. When the auditors were preparing the financial statement for the year-ending September 30, 1990, they relied upon what had been reflected on the general ledger. In the 1990 financial statement, the Balance Sheet listing of "Long-term liabilities" no longer listed the "note payable- general partner." On the Statement of Cash Flows, under the heading "Cash flows from financing activities," there was a decrease of $212,033 for "Reduction of advances to general partners," and a decrease of $5,932 for "Payment of accrued interest, general partner." Note 4 to the financial statement, "Related parties," states in pertinent part:

> During the year ended September 30, 1990, $5,932 of accrued interest on operating loans, from the year ended December 31, 1987, was paid to the general partners.
>
> A note payable of $212,033 to Community Housing and Research Corporation for unpaid development fees was repaid during the year ended September 30, 1990.

JE-EH 1990; Tr. 150-51, 281.

123. In the summer of 1991, during the course of her work related to the CMC audit, Ms. Flaherty discovered that the $212,033 had all along been incorrectly recorded as a note payable to CHRC and should have been shown as a deferred development fee payable. Ms. Flaherty notified Mr. Weitz of the error and the two discussed how the error, which resulted in payment of development fees using surplus cash, would best be rectified. Using April 20, 1990, as the date, they calculated the amount of principal and interest that was due back to the partnership, and assigned to the partnership a corresponding portion of funds in a repurchase agreement held by CHRC. When the repurchase agreement came due, the amount that had been assigned was paid over to the partnership and deposited in three separate FDIC-insured bank accounts in the name of the project. Tr. 147-48, 152, 281-84; NP-4.

124. On the compiled financial statements[96] for Reynolds Associates for the years ending September 30, 1991, and September 30, 1992, a development fee payable of $212,033 is listed under Liabilities and Partners' Deficit. On the Form 1065-Partnership tax return filed by Reynolds Associates for the year ending September 30, 1992, $212,033 is listed as a liability. JE-EH-1991C; JE-EH-1992C; R-1; Tr. 166-67, 171-72, 285.

125. To reflect that the development fee was still owed to CHRC by the Reynolds Associates partnership, the limited dividends payable were reduced on the 1991 and 1992 financial statements for the Essex House project. *Compare* JE-EH 1990 at 3 *with* JE-EH-1991 at 3, JE-EH 1992 at 4.

Count IV: The Alleged Failure to Properly Maintain Essex House and Pemberton Manor

[96]The compilations were prepared in response to the RIGA's audit of CMC, after which the partnership's books were kept separately from the project's books. Accordingly, the record includes separate partnership and project financial statements for 1991 and 1992. Tr. 167-68, 186-87, 285; JE-EH 1991C; JE-EH 1992C; JE-EH 1991; JE-EH 1992.

126. Paragraph 7 of the Regulatory Agreements for Pemberton Manor and Essex House state: "[o]wners shall maintain the mortgaged premises, accommodations and the

grounds and equipment appurtenant thereto, in good repair and condition." AR-4A, ¶ 7; AR-4B, ¶ 7.

127. The Loan Management Branch in each HUD Field Office oversees a physical inspection program for insured and assisted multifamily projects. HUD's interest is in ensuring that tenants are physically protected and that its security for the mortgage, *i.e.*, the property, is preserved. A HUD construction analyst with a more technical background than a loan specialist typically makes the physical inspection. When a loan specialist makes an inspection, it is a non-technical review. Mortgagees make their own inspections apart from those made by HUD. Notification of the findings made during a HUD inspection is required to be provided to the owner on form HUD-9822, Physical Inspection Report. The reports are typically prepared by the construction analyst, but on occasion are prepared by the loan analyst. Tr. 724-27, 770-71, 795; PI-6; PI-7.

Essex House

128. Essex House is a 14 story high-rise that sits elevated on a bluff. The roof is flat and is not visible from the ground.[97] R-2 at 1; Tr. 755-56, 1548.

129. The Essex House roof was first installed in November to December 1974, and had a 20-year, bonded life. There have been problems with the roof attributable to construction defects, ever since its installation. It is a built-up roof, comprised of four or five layers of roofing felts impregnated with hot bitumen. Under ideal conditions the layers bond to each other, providing a roof that does not leak and has a good appearance. When the Essex House roof was installed, moisture that had accumulated on one layer was not removed before the next layer was put on. As a result, the layers did not bond tightly to each other, forming pockets of trapped moisture in certain areas of the roof. In the summer, when the roof gets heated, the pockets of moisture expand and blisters form. This unattractive and spongy condition of the roof was apparent during construction and prior to final endorsement of the loan. The roof did not leak at that time. Tr. 1546-48, 1619-20; R-2 at 1.

[97] Essex House is a family project, not one for the elderly. Tr. 760. The Amended Complaint, however, alleges that Mr. Weitz' actions have "threatened the well being of the projects' tenants, all of whom are elderly." *See* Amended Complaint at 21, ¶ 108.

130. In a report dated February 21, 1977, the Law Engineering Testing Company ("Law Engineering") outlined and evaluated roof and masonry construction defects at Essex House.[98] Mr. Weitz had hired Law Engineering because of "severe water penetration problems" that had been experienced at the upper areas of Essex House. Specifically, the report noted that since June 1975, leakage had been reported in some of the apartments; during and immediately following periods of rain and high winds in August 1975, interior water damage in the upper floors and some downstairs apartments had occurred; water damage had occurred in September 1975 in an apartment where subsequent removal of wall sections disclosed seepage of water through the brick and mortar joints; and sealants had been used in an attempt to stop leakage into the elevator equipment and stairwell penthouses. To evaluate the possible causes of these problems and to suggest corrective measures, Law Engineering reviewed the building's architectural and structural drawings and specifications, examined the building's "as-built" condition, and tested various building components. In doing so, the report addressed such issues as the incompatibility of concrete with construction materials, the leaking through walls, the effect of weather conditions,[99] the state of the built-up roofing, and the detailing and drafting for construction. R-2 at 1-13.

131. Upon review of the project drawings and specifications, the Law Engineering report concluded that discrepancies from standard recommended practice and construction methods existed. Specifically, the report noted the following: horizontal expansion joints (soft joints) at each level and roof line, which prevent the transmission of structural loads to the masonry walls, were not detailed; the design of the masonry roof parapet allowed water to migrate down the masonry walls, encouraging saturation of the walls; the wall section details did not clearly call for weep holes at least every four feet as required by HUD and common practice; expansion joints were not detailed at least at the first window opening from each end of the structure, thereby allowing for expansion of the building; and project drawings did not clearly detail the wall flashing in the penthouse walls as required by HUD. R-2 at 13-14, 23.

132. The Law Engineering report stated that visual inspection of the roof "indicated a significant amount of water standing over a good portion with three drains at elevations slightly above the water." Visual inspection also revealed "[p]erhaps a dozen blisters" which had "subsequently been repaired." Based upon samples removed from the roof system, the report found that the roof complied with HUD requirements, but that the weight of crushed stone surfacing used was less than required. The report also found that the roof did not comply with the material supplier's specifications. The report found that the flashing system was out of compliance with project documents and

[98]Respondents assert, and the Government does not deny, that the Law Engineering Report was made available to HUD in 1977. *See* Respondent's Post-Hearing Brief at 34.

[99]The report stated that Essex House was located in a "'severe' weathering area." R-2 at 9.

the supplier's specifications. Specifically, no cant had been used, specified felt had not backed up the flashing sheet, the flashing was not bonded to the parapet, the flashing detail in the roof parapet did not comply with the project drawing, and the parapet detail at the face of the building was constructed incorrectly. The report predicted that the roof would require continued maintenance. R-2 at 15-16, 24, 26.

133. The Law Engineering report found the masonry construction at Essex House, in general, to be poor to average. The report determined that "the major reason for the leakage experienced" was that the contractor had not constructed the wall sections in total accordance with the project drawings and standard practice. The report further noted the following: weep holes were totally lacking from the masonry work; vertical cracking in 5% to 10% of the brick had occurred; horizontal cracking in the masonry bed joints had occurred, including on the outside of the masonry parapet at the roof line; vertical cracking of the masonry facing had occurred; wall flashing was lacking at the base of the penthouse walls; and no damp proofing was observed on the inside of the masonry construction at window openings, behind all furring or in any of the equipment rooms examined. Tests of the brick masonry, mortar, and parging, revealed that the bricks were not moistened prior to use as required by the project documents, that the mortar used resulted in less-than-effective consolidation, that some of the mortar used was not the type required by HUD and the project documents, and that some of the parging used was not of the type required by project documents. Other tests revealed saturation issues with regard to the concrete block, brick, mortar, and parging that had been used. Visual inspections of certain apartments revealed evidence of some water staining, leakage and dampness. R-2 at 17-22, 24-26.

134. The Law Engineering report concluded:

> If the building had been built in accordance with good practice it would have had a life expectancy of 50 years or more with little maintenance required as is adequately demonstrated by older uncracked masonry structures in the Washington area. By not correcting the present conditions, the life expectancy of the structure will be greatly reduced and continual stop-gap maintenance will be required.

In setting forth its recommendations, the report stated that in waterproofing against wind driven rain, openings in the masonry walls were the most important and most difficult to resolve. Moreover, because of the numerous other problems with the design and construction of the structure, the report stated that it could not recommend, as it otherwise would have, that the solution to water penetration issues at Essex House be limited to sealant work. Instead, the report recommended that seven other steps be taken, including "[r]eplacement of the existing roof system, (including flashing, particularly roof to parapet) with a properly installed system." The report estimated that "[r]eplacement of roof and installation of metal coping" would cost $40,000, out of a total recommended repair budget of $300,000. R-2 at 26-29.

135. In 1983, Mr. Weitz applied to HUD for a flexible subsidy loan in the amount of $800,000, the proceeds of which were to go towards, *inter alia*, roof and window repair and replacement. The loan application was granted, but the money was not borrowed because other Reynolds Associates partners did not want to execute the loan commitment which restricted use of the project as low-income housing for an additional

55 years. Tr. 1549, 1551.

136. From 1986 through late spring or early summer of 1992, when Judy Heyde was the HUD loan analyst for Essex House, she neither visited the property nor was aware of any pattern of roof or window leaks.[100] During those years, Essex House was not a priority for Ms. Heyde who spent her time on projects with problems. No management reviews were conducted during this period. Ms. Heyde was aware that there were problems with the roof at Essex House, and that Mr. Weitz attributed those problems to construction deficiencies.[101] Ms. Heyde was also aware that although Mr. Weitz had not requested use of the reserve fund for replacements for roof repairs, he had used that fund to repair certain elevators at Essex House, which were "high cost" items. Tr. 727, 738, 747-49, 756-57, 760, 764-65, 793.

[100]Ms. Heyde, testified that she *believed* the roof was leaking based upon reading a June 14, 1989, inspection report, discussed *infra*, and having been advised by Paul Turner, the Essex House resident manager, that one leak had occurred. Tr. 757-58, 770. Both Mr. Weitz and Robin Pelton, the Essex House property manager, testified that one such leak occurred. *See, e.g.*, Tr. 917, 1609-10.

[101]Ms. Heyde testified that she did not recall having seen the Law Engineering report. Tr. 749-50. *But see supra n.98.*

137. By letter dated March 30, 1989, Mr. Weitz submitted information to Ms. Heyde in support of a rent increase request for Essex House that had been made on March 1, 1989. The increase was to cover the debt service on a loan in the amount $800,000 for ten years at a 15% interest rate. Mr. Weitz proposed to use the proceeds of the loan, *inter alia*, to replace the roof and repair the parapet wall,[102] and replace the windows at Essex House.[103] He estimated that because window installation would cost $500,000 and roof installation, $100,000,[104] the reserve fund for replacement would be

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[102]Regarding replacement of the roof and repair of the parapet wall, Mr. Weitz wrote:

> The third item of energy conservation measures would be to install a new roof at Essex House. It is likely that, the present built up roofing was installed directly over the concrete deck. There is evidence of little or no insulation underneath the current roof plys. Furthermore, it is evident from the number of blisters and bubbles on the surface of the roof that moisture is penetrating the asphalt layers or is trapped under the roofing from original construction. Inspectors from HUD who examined this roof in the early 1980's characterized it as one of the worst roofs they had ever seen. Not only is the roofing defective, but so are all of the flashing, counterflashing, and contiguous construction to the roofing membrane, such as the parapet walls and reglets. We have been advised by roofing consultants and professional roofers that this roof should be torn off down to the concrete; and then, the concrete should be carefully examined to determine whether there has been deterioration. If deterioration is evident, it should all be removed and repaired to a like-new condition. An impermeable membrane would then be placed upon the restored concrete, and then insulation, having a value of R-30 or better, would be installed.
>
> The insulation should be of a polyisocyanurate or equal quality and should be tapered to the drains. Savings from the insulation will be tremendous because of the high insulation value versus a very nominal or minimal insulation value (with obvious moisture) existing in the present system. Several years ago we had received estimates to perform a roof restoration of lesser quality from several prominent Washington area roofing companies. Their estimates ranged from a minimum of $100,000.

R-3 at 3-4.

[103]Regarding replacement of the windows, Mr. Weitz wrote:

> Historically, the in-place windows at Essex House have been troublesome since the building was first completed. The windows leaked, and had to be recaulked and all new weather-stripping installed. Over the years, this problem of leaking has been constant because of the fact that these inexpensive, poorly made windows which were also improperly installed, were not worth the money and effort it would take to attempt to bring them up to suitable condition. In fact, the in-place windows were tested by a nationally renowned engineering professor from the University of Miami who indicated that the windows did not conform with the ASTM criteria and AAMA standards.

R-3 at 2.

[104]The remaining $200,000 was allocated to repair and renovation of the parking lot. R-3 at 4.

inadequate to complete the proposed repairs. In closing, Mr. Weitz stated:

> Finally, we wish to reiterate the importance of granting our rent increase at this time, and not subject us to having to reapply at a later date when the actual cost for performing the various work and the costs of financing are fixed. To do so, would be to subject the owner and managing agent to double jeopardy with respect to these substantial and essential improvements. Furthermore, should this approach be taken by your office, then the undersigned can assure that no further efforts to make these or any other planned improvements will be undertaken. Alternatively, we ask that you approve the increase at this time, subject only to staged implementation when, as and if the improvements program goes forward.

R-3. *See also* Tr. 738-39, 750-51, 1550, 1568, 1611.

138. On June 14, 1989, Herman Ransom, a construction analyst with the HUD D.C. Field Office, conducted a physical inspection of Essex House. Mr. Weitz accompanied Mr. Ransom on the inspection. The inspection was undertaken at the

request of Ms. Heyde, in order to evaluate Mr. Weitz' rent increase request and related loan proposal. PI-1; Tr. 728, 751-52, 1567-68, 1609-10.

139. Mr. Ransom prepared a physical inspection report dated June 14, 1989. The report was sent to Mr. Weitz under a cover letter dated July 11, 1989, from William W. Hill, Chief of the Washington, D.C. Field Office Loan Management Branch. In his report, Mr. Ransom concluded that the property was in "satisfactory" condition, and that the maintenance policies and procedures were "superior." The report cited a "high urgency" need for maintenance on the roofs, flashing, and vents, and a "[n]eed to replace roof and all flashings at parapet walls." The report also cited a "medium urgency" need for maintenance on the caulking and weatherstripping, noting that the "[w]indows need recaulking throughout." The report included the following note:

> Randomly inspecting 15 units at Essex House, it was determined that the property is being very well maintained. We hope that this practice continues in the future. Also inspected was [sic] 3 supply rooms, the Day Care facility, boilerroom, playground and pool area. These areas also seemed to be kept and maintained in a professional manner.

The last page of the report contained the following statement concerning Mr. Weitz' proposal to replace the windows:

> I would agree that any type of energy efficient windows installed would certainly be a savings to the property. However, after inspecting units and windows I do not see the need of replacing any of the windows. The leaks that are occurring are coming from the flashing at parapet walls on roof. Water is seeping down walls and into units where windows are installed. I would agree that some of the windows are improperly installed, however, if flashing and roof are replaced the water problem more than likely would cease. Therefore, I would certainly recommend and support a new roof system.

The cover letter from Mr. Hill directed Mr. Weitz to provide a property improvement plan by July 31, 1989, for the correction of items marked "high" and "medium" urgency, including target dates for completion of the corrective work. Mr. Hill stated that upon receipt of the plan, he would be willing to meet with Mr. Weitz "to discuss these deficiencies further and/or work up a plan of action that is mutually acceptable." Mr. Hill referred to Mr. Ransom's comments concerning Mr. Weitz' March 30, 1989, proposal, but did not respond directly to the proposal.[105] PI-1. *See also* Tr. 728-30.

[105]Neither Mr. Ransom nor Mr. Hill was called to testify at the hearing. Mr. Ransom's report does not indicate that he actually saw any leaks or whether he only learned of leaks from Mr. Weitz' March 30, 1989, letter to Ms. Heyde (R-2), or from comments made to him by Mr. Weitz during the inspection. Indeed, Mr. Weitz testified that he accompanied Mr. Ransom on the inspection, that neither of them determined that there was any water penetration into the building, and that he agreed then and now that

the parapet wall flashing was deficient. Tr. 1609-11. The report does not indicate the location of any apartment with a leak; therefore, one cannot conclude that any top-floor unit had a leak, or whether any leak could more likely be attributed to the windows or mortar cracks, rather than the roof.

140. Mr. Weitz and Ms. Heyde discussed Mr. Hill's letter and Mr. Ransom's report. Ultimately, HUD rejected Mr. Weitz' March 1989 rent increase request.[106] Tr. 730, 739-40, 1550.

141. In January 1991, Mr. Weitz made another request to HUD for an increase in the rents at Essex House. As the roof was nearing the end of its useful life, the request was calculated to include a ten-fold increase in the amount of the reserve fund for replacements, which Mr. Weitz intended to use to replace the roof. This request was approved by HUD, and the reserve for replacements increased. Tr. 1551.

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[106]Ms. Heyde attributed HUD's failure to act on the proposal to a "paper war [having] started over the rent increase." When asked what she meant by "paper war," Ms. Heyde explained:

> Just constant back and forth. There was a loan. Mr. Weitz wanted to incur a loan and have that paid out of project funds, and so in order to do that, we would have had to have done a rental increase. So we had specific questions that we asked him in writing. We had letters going back and forth. In the meantime, Mr. Weitz chose to -- what we call -- taking opt-out on his Section 8 contracts at Essex House, and this is a process by which -- that they have to give the resident, like, a one-year notice, and there was problems throughout with the opt-out and trying to get the rent increase documents. We asked for certain things to document. We had to ask certain questions about expenses, and it just got to the point where we were just firing letters back and forth, and we really -- things go[t] so heated up, especially with the opt-out, and we felt that Mr. Weitz didn't follow certain required procedures. And it eventually resulted in Mr. Weitz suing the Secretary over the opt-out provisions and conditions. So it got very heated up and not a pleasant situation.

Tr. 739-40. *See also* Tr. 760-64.

142. On August 21, 1991, Harold Fisher, an inspector working on contract with the D.C. Field Office, conducted a physical inspection of Essex House. Mr. Weitz accompanied Mr. Fisher on the inspection.[107] Mr. Fisher's report, dated August 23, 1991, rated the overall physical condition of the building as satisfactory and the maintenance policies and practices as satisfactory. The report cited a "high urgency" need for maintenance on the roofs, flashing, and vents, and commented that:

[107]Mr. Fisher was not called to testify at the hearing. Ms. Heyde did not recall whether she or the Chief of the Loan Management Branch had requested the inspection or whether it was a scheduled, routine inspection. Tr. 731.

> (a) Entire built-up roof is in need of replacing, complete w/flashing, due to extensive repairs, possible obsolescence, blister areas, inadequate drainage (roof is currently approx. 18 yrs. old). Total replacement is recommended complete with insulation. Refer to photos.
>
> (b) Recommend re-design & installation of parapet suitable for existing building design. Currently there is partial metal coping with no expansion provided & the balance of coping is w/masonry & open masonry joints that allows water seepage & penetration into wythe & down through walls & into dwellings. Refer to photos.

PI-2. *See also* Tr. 730-33.

143. On November 6, 1992, U.S.G.I, Inc., the Essex House mortgagee, inspected
Essex House. In a report made on the same form 9822 used by HUD, the mortgagee's inspector stated that the project's overall physical condition and maintenance policies and practices were satisfactory. The report further stated that no maintenance was needed on the roofs, flashing and vents.[108] The comments to the report stated:

> The building is sound structurally and appears to be maintained and managed effectively. When the painting and carpeting projects are completed, the property could easily earn a superior evaluation.

R-4. *See also* Tr. 847-849.

144. In December 1991, Robin Pelton, a property manager employed by CMC, was assigned to Essex House. At the time, Ms. Pelton was aware that there were problems with the condition of the roof, but understood that there were no leaks. She began development of a capital improvement plan which was to incorporate a long-term solution to the problems with the roof. During the period of December 1991 to June 1994, Ms. Pelton received only one tenant complaint concerning a leak. The leak

[108] In describing the areas that were inspected, the roof was not specifically mentioned. Moreover, of the units inspected, none appears to be a top floor unit. R-4.

occurred in or about June 1993 and was repaired.[109] Tr. 914, 916-17.

[109]Ms. Pelton did not specify whether or not the leak was attributable to the roof. However, Mr. Weitz testified that other than around the windows, there has been no water penetration into an Essex House unit. In any event, Ms. Pelton testified that the leak she referred to was minor and repaired. Tr. 917, 1609-11. This testimony is consistent with the unrefuted evidence that annual inspections of every unit in the building by the City of Alexandria have never found water penetration problems. Tr. 1569-70.

145. On December 3, 1992, Ms. Heyde[110] and Donald McSherry, a construction analyst with the D.C. Field Office, conducted a site visit at Essex House. The purpose of the visit was to evaluate the property's condition in preparation for the LDP conference to be held the following week in Philadelphia, Pennsylvania.[111] It was the first time Ms. Heyde had gone to Essex House since 1986 when she had been assigned as the loan analyst. Mr. Weitz was present at the visit during which those in attendance went up on the roof. No units were inspected. PI-3; PI-4; Tr. 733-34, 738, 747, 797-800, 806-07, 836, 855, 1612.

146. During the December 3, 1992, site visit, Ms. Heyde observed that the roof surface was "mushy," that her heels were "sinking into the roof," that the roof surface appeared "bubbly or cracked," and that "there was missing flashing."[112] Mr. McSherry observed that certain areas of the roof surface had standing water and were soft, which he believed was indicative of water retention and a drainage problem. He also observed that other areas of the roof surface which were dry had voids and cracks, that at least half of the flashing along the edge of the roof surface was either loose, bent up where water could get under it, not adhered properly, or missing.[113] Tr. 735, 807-08, 832-33, 851.

147. Mr. McSherry prepared a rapid reply letter to Ms. Heyde, dated the same day as the visit, which stated:

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[110]By this time, Ms. Heyde was no longer the loan analyst for Essex House. She visited Essex House solely in preparation for the LDP conference. Tr. 747.

[111]Ms. Heyde testified that it was her understanding that the purpose of the meeting to be held in Philadelphia was "to resolve the outstanding IG audit or to come to some kind of an agreement to bring all the back-and-forth correspondence to a close and to, hopefully, resolve some of the issues and put it to rest." Tr. 734. In her view, because the LDP resulted from the audit, it is unimportant whether the meeting held in Philadelphia is referred to as an LDP or an audit resolution conference. Tr. 797-98.

[112]Ms. Heyde took photographs of the roof, including a photograph she believed showed missing flashing. AR-37; Tr. 734. According to Mr. Weitz, however, there is no missing flashing; only areas where because of the nature of the roof's construction, none was intended. Tr. 1552-54, 1611-16, 1625-28. Having reviewed the evidence, including the photograph taken by Ms. Heyde, I cannot conclude that there was any flashing missing. The photograph shows that a portion of the rowlock on top of the parapet wall is not covered by metal coping. Metal coping never covered the entire expanse of rowlock.

[113]Mr. McSherry testified that when he went out on the site visit he "didn't know anything about the roof," including the roof's age. He did not inquire whether there had been any history of failure with the roof, including a history of any leaks. He testified that he didn't inquire into such matters during the visit because he listened to the conversations of others in attendance. In that context, he testified that he overheard that a prior report had indicated that there were window leaks, which he assumed meant top floor leaks. He also testified that he did not review the inspection reports prepared by Mr. Ransom in 1989 and Mr. Fisher in 1991 until he returned from the site visit because he "[doesn't] like to be influenced by what someone else says is wrong with the property." Tr. 834-36, 810.

> When comparing the previous two (2) physical inspection reports (dated 8-21-91 and 6-14-89) with my findings today, I found that great progress has been made in those line items with a small dollar amount required to correct, but virtually no action taken on major deficiencies previously annotated[114]. . . .
>
> The roof which is in urgent need of total replacement, plus major repairs to the parapet wall, has been ignored. Additionally. . . energy efficiency - entire bldg. needs double glazed thermal windows in lieu of existing ones. . . .[115]

PI-4. *See also* Tr. 809-13.

148. After receiving Mr. McSherry's comments, Ms. Heyde prepared a physical inspection report dated December 3, 1992, which cited a "high urgency" need for maintenance on the roofs, flashing, vents, exterior walls, and foundation. PI-3. *See also* Tr. 736-38.

149. In or about March 1993, two units at Essex House experienced moisture problems. The problems resulted from an experimental repair to the parapet wall, using a new flashing product that had come to Mr. Weitz' attention. After obtaining a sample of the product and the specifications for its use, the product was applied to a section of the Essex House roof to test the results. When the moisture problem occurred, a temporary repair was made, and later, when the weather improved, a permanent repair was completed. Tr. 917-19.

[114]Mr. McSherry acknowledged that such deficiencies included, but were not limited to, the roof. Tr. 812-13.

[115]Mr. McSherry testified that the parapet wall needed to be redesigned as it is not a proper wall for the type of building. Yet, as discussed *infra*, he attributed none of the problems with the Essex House roof to construction defects, distinguishing roof manufacturing defects from building construction defects. Tr. 811, 832.

150. At the request of Ms. Heyde, Mr. McSherry made a physical inspection of the Essex House roof on April 8, 1993.[116] He noted that the overall condition of the roof

[116]The record does not support a finding that Mr. Weitz intentionally attempted to prevent Mr. McSherry, or any other HUD employee, from inspecting the roof. According to Mr. McSherry, he had arranged with Paul Turner, the Essex House resident manager, to make a physical inspection of Essex House on April 7, 1993, but that during the inspection of April 7th, he was advised by Mr. Turner that Mr. Weitz had left instructions that no one was allowed on the roof. On April 8th, without conferring with Mr. Weitz, Mr. McSherry went back to Essex House and induced a maintenance man to allow him onto the roof. Neither Mr. Turner nor the maintenance man was called to testify, and Mr. McSherry acknowledged that he never spoke directly to Mr. Weitz about what he had been told by Mr. Turner. Tr. 813-16, 839-41. Moreover, according to Mr. Weitz, he and Mr. McSherry had arranged a date to meet at Essex House, but Mr. McSherry chose to visit prior to the arranged date. Mr. Weitz further testified that he never left an order at Essex House not to let Mr. McSherry on the roof, but that there was a standing order at all his high-rise buildings not to permit individuals on the roof unless the person had a certificate of insurance or had sought prior approval from the management company's main office. Tr. 1554-56. Mr. Weitz' testimony was corroborated by Ms. Pelton, who testified that prior to Mr. McSherry's visit, she had advised Mr. McSherry that Mr. Weitz had requested that he be present for the inspection. She also testified that she had received a call from Mr. Turner during which he advised her that he had been called by Mr. McSherry. Ms. Pelton advised Mr. Turner of Mr. Weitz' instruction that he attend the inspection and that

was no worse than it had been on his previous visit to Essex House on December 3, 1992. In his opinion, the same amount of flashing was either loose or missing, and although there was still water standing on the roof, it was not as much as in December 1992. Tr. 813-17, 839-41.

151. On or about April 14, 1993, Mr. McSherry inspected the apartment unit interiors with Mr. Weitz present. Of the 20 or so units that he inspected, including 3 top-floor units, Mr. McSherry did not observe any leaks or condensation on the windows or any signs that the windows had been improperly installed. Tr. 817-18, 820-21, 846, 855, 862-63.[117]

152. In a physical inspection report dated April 15, 1993,[118] Mr. McSherry cited a "high urgency" need for maintenance on the roofs, flashing, and vents. PI-5 at 1. The comments to the report included the following statement:

> The entire built up roofing system needs to be replaced completely. Existing roof is 21 years old. New system must give special attention to drainage and parapet walls and flashing. . . .

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he be contacted to set up an appointment. Tr. 919-20.

[117]The record does not support a finding that Mr. Weitz intentionally attempted to prevent Mr. McSherry from inspecting top floor units. Mr. McSherry testified that prior to the inspection, he had advised the Essex House resident manager, Mr. Turner, that he wanted to see as many top floor units as possible because of the condition of the roof and because he "suspected there would be leaks." According to Mr. McSherry, on the day of the inspection, he met with Mr. Weitz and was able to inspect only 3 of the 16 to 20 top-floor units as he was told there was no pass-key and in only 3 units did a person answer a knock on the door. However, he further testified that he did not pursue inspection of additional top floor units because it "was not that important," since "just because [the roof] doesn't leak into everybody's apartment doesn't mean that the roof does not need to be replaced." Tr. 820-21, 843-46, 855, 857.

[118]The report indicated that the inspections had occurred on April 7 and April 14. It did not indicate that the roof had actually been inspected on April 8. PI-5; Tr. 817.

Many items noted for 'maintenance needed' in two previous HUD reports (8-21-91 and 6-14-89) have been ignored. (e.g. roof,driveway, garage) This is the basis for my below average evaluation of the overall physical condition. Additionally, the

> owner threatens to perform no more repairs covered under reserve for replacement, unless he gets money up front.

PI-5 at 2, 4; Tr. 818-20.

153. In Mr. McSherry's opinion, the entire roof system at Essex House should have been replaced in 1989 or 1990, and the roof system has not performed adequately since that time, given the evidence of drainage problems which will "break the roof system down." Mr. McSherry bases his opinion on his visual observations of the roof's condition and on Mr. Ransom's 1989 report indicating that there had been leaks. Mr. McSherry is also of the opinion that the problems he observed in the roof system can "absolutely" not be attributed to construction defects.[119] Tr. 810, 824, 855, 857-58.

[119] Mr. McSherry's conclusion from Mr. Ransom's report that there was a problem with the roof assumed that the leaks referred to by Mr. Ransom were top floor leaks into the units. However, Mr. Ransom's report does not state that window leaks occurred on the top floor. Mr. McSherry acknowledged that he found no top floor window leaks, and that he had no basis for assuming that the leaks to which Ransom referred occurred on the top floor. Indeed, he testified that if those leaks were not top floor leaks, they would not have been caused by problems with the roof. Moreover, he assumed that any condensation or leaks in the windows were caused by a deficient roof system, rather than by improper window installation. Yet, he acknowledged that if leaks were occurring in top floor unit windows, and if those windows had been installed improperly, the cause of the leaks would not necessarily be attributable to the roof. He also testified that even if he had seen the Law Engineering Report, or any other materials filed with HUD discussing construction defects, (which he had not), he would not change his opinion that the problems in the roof system "absolutely" could not be attributed to construction defects because the roof had been warranted by the manufacturer. This testimony stands in sharp contrast to HUD inspector LaPierre's testimony that roof warranties are meaningless. What is important to him is the quality of the roofer's installation work and whether the roofer is bonded. Tr. 820, 824-25, 827-32, 842, 855, 859-63, 904-05.

154. On October 13, 1993, U.S.G.I., Inc. again inspected Essex House. In a report made on form HUD 9822, the mortgagee's inspector once again stated that the project's overall physical condition and maintenance policies and practices were satisfactory. The report further stated that no maintenance was needed on the roofs, flashing and vents.[120] The comments to the report stated:

> Satisfactory evaluation given as it is obvious that the management cares very much on the overall appearance of the complex. There is a Preventative Maintenance Procedures program each month of the year.

R-5. *See also* Tr. 849-850.

[120]In describing the areas that were inspected, the roof was not specifically mentioned. Moreover, of the units inspected, none appears to be a top floor unit. R-5.

155. As part of a proposal to replace the Essex House roof, Ms. Pelton, in December 1993, sent to HUD specifications prepared by an engineer. Replacement reserve funds were targeted as the source of funding. In March 1994, Mr. McSherry was advised of the proposal by Karen Sidlars, the loan servicer for Essex House. Based on his knowledge of the roof, he evaluated the proposal and deemed it "very good." The specifications have been approved by HUD and have been sent out for bid. It is anticipated that once HUD approval is obtained to use the reserve for replacement funds, the work will take 45 to 60 days to complete.[121] Tr. 821-24, 853, 920-21, 931-33, 1551-52.

Pemberton Manor

156. Pemberton Manor is a low-rise garden apartment complex[122] with 19 separate apartment buildings and a community building. It is located in an area that experiences high winds. The roofs are pitched and shingled. Tr. 874, 922-23, 1559.

157. The Pemberton Manor roof system was defectively constructed.[123] Most significantly, the gable end walls protrude beyond the roof sheathing, causing the sheathing and shingles to turn up at the edge of the building, and the shingles to blow off, particularly in high winds. Repairs have continuously been made to maintain the roof. Tr. 1556-57, 1559-60, 1619-20.

158. In March 1977, CHRC applied to HUD for an OLL in the amount of $580,500, $250,000 of which was to have been placed in escrow for the correction of construction deficiencies at Pemberton Manor. Having been advised that the program pursuant to which the loan was being sought did not allow the $250,000 item, CHRC reapplied for an OLL in April 1977, equal in amount to the operating losses that had been incurred. Discussions between Respondents and the Baltimore Field Office and HUD Headquarters concerning funding for repair of the roofs continued through the summer or early fall of 1977, when Respondents were advised that no funding mechanism was available. *See supra* Finding Nos. 98-99, Count II. *See also* Tr. 1557, 1571-73.

159. In 1983, Mr. Weitz applied to the State of Maryland Community Development Administration for a loan under their Home Energy Loan Program

[121]It was anticipated at the time of the hearing that the work would be started during the summer of 1994 and completed during the fall or early winter of 1995. Tr. 1551-52.

[122]Like Essex House, it is a family project, not one for the elderly.

[123]The Amended Complaint refers to Mr. Weitz' purported failure to maintain in good condition and repair the "roof, trusses and other underlying roof structure," but, as detailed *infra*, the Government's evidence focuses solely on the roof surface. *See* Amended Complaint at 20, ¶ 105.

("HELP"). The Community Development Administration agreed to make a loan of $1,350,000 to correct the roof and to change the heating, ventilation and air-conditioning ("HVAC") system.[124] Mr. Weitz applied to HUD to get its approval for the loan, and as of the date of the hearing, had received no response. Tr. 1557-59.

160. In 1988, Mr. Weitz requested that the mortgagee for Pemberton Manor prepare a feasibility analysis and submit a request to HUD on his behalf to finance the cost of renovating the roofs at Pemberton Manor. The analysis and request were presented to Diana Brown, Chief of Loan Management in the Baltimore Field Office. Ms. Brown informed Mr. Weitz a month or two after the proposal had been submitted that HUD would not concur because it would result in rent increases beyond what was considered reasonable and within the tenants' ability to pay. Tr. 1559.

161. On October 25, 1990, Metmor Financial Inc., the Pemberton Manor mortgagee, conducted an inspection of Pemberton Manor. In a report made on the same Form 9822 used by HUD, the mortgagee's inspector stated that the project's overall physical condition and maintenance policies and practices were satisfactory. The report further stated that there was a "high urgency" need for maintenance on the roofs, flashing, and vents. The comments to the report stated, *inter alia*:

> Roofs need to be replaced in several areas, shingles appear to have blown off. . . .
>
> Overall the complex appears to be in good condition with the exception of the above mentioned.

PI-8. *See also* Tr. 908-09.

[124]Mr. Weitz testified that to participate in HELP, the loan had to have an energy conservation component which, in the case of Pemberton Manor, was the HVAC system. Moreover, according to Mr. Weitz, the savings that would have resulted from the new HVAC system would have paid for the debt service on the entire loan. Tr. 1558.

162. On July 16-17, 1991, George "Rick" Owens, a construction analyst with the HUD Baltimore Field Office, conducted a physical inspection[125] of Pemberton Manor with the assistance of Gary LaPierre, another construction analyst with the HUD Baltimore Field Office.[126] Mr. LaPierre went on the roof and observed that shingles were missing or were cupping, and that the shingles and flashing needed to be replaced. The physical inspection report[127] cited a "high urgency" need for maintenance on the roofs, flashing, and vents. The comments to the report included the following statement:

> FINDING: All roofs are in need of replacement. The gable ends of the buildings that were visible exhibited signs that the construction guidelines were possibly not adhered to. This could cause the wooden fascia to loosen and fall from the buildings. The missing sill plate does not provide the necessary nailing surface for the end of the plywood. This causes the plywood at the gable end to cup up. The waste vent boots are deteriorating and not sealing.
>
> CORRECTIVE ACTION REQUIRED: Remove all shingles and building paper down to the plywood. Remove and discard the

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[125]The physical inspection was part of a comprehensive management review of Pemberton Manor on July 16-17 and 23, 1991. The cover letter, by which the report was forwarded to Mr. Weitz as the General Partner of Pemberton Manor Associates, c/o CMC, stated:

> The report reflects an overall rating of Below Average. This means that the policies and procedures established by management are either weak, inappropriate for the project or are not being followed. This has resulted in frequent failures to meet HUD's requirements. . . .
>
> THIS REPORT COULD AFFECT YOUR PREVIOUS PARTICIPATION CLEARANCE. If a Below Average rating is not appealed within 30 days or is appealed and sustained, a copy of the Management Review Report must be placed in our Headquarters file and considered during any future 2530 clearance processing. Previous Participation Clearance can be denied unless acceptable progress is made in resolving serious violations, i.e., generally those findings for which the phrase "Corrective Action Required" is used.

GX-3.

[126]During 1990, Mr. LaPierre had conducted his own site visit at Pemberton Manor, determining that the roofs and flashing should have been replaced 4 to 5 years earlier. Tr. 868-69, 871-73, 878, 890. As support for Mr. LaPierre's observation, not memorialized in any report introduced into evidence, the Government cites to the physical inspection report issued by the mortgagee in 1990. *See* PI-8, discussed *supra* Finding No. 161. These are the same reports for Essex House and later Pemberton Manor which the Government argues are unreliable. The Government cannot have it both ways, *i.e.*, adopt the mortgagee's findings only when they support the position being taken by it, but seek outright rejection of the reports when they are adverse to its position.

[127]Respondents did not receive the unsigned report until February 1992. GX-3; Tr. 910.

> existing ridge vent and vent boots. Remove and replace any plywood that is improperly installed. Install new half inch plywood intended for roof sheathing over existing sheathing. The joints are to be staggered and clips used. Submit specifications to our office for review prior to bidding. When approved, obtain three (3) written estimates for our review and approval.

GX-3.[128] See also Tr. 864, 873-74, 888, 898.

[128]While the RIGA Audit Report mentioned the Essex House roof, it did not mention the roof at Pemberton Manor. The first notation of problems with the roofs at Pemberton Manor is the July 1991 inspection report (PI-8).

163. During the fall and winter of 1992, high storm winds caused significant damage to Pemberton Manor, including shingles falling off the roof. Bids to replace the missing shingles were obtained, and a request was made to HUD to determine if $13,000 of reserve funds could be used to make repairs. In addition, claims were filed with the property's insurer.[129] Not having received a response from HUD, Ms. Pelton recommended, and Mr. Weitz determined, to take interim corrective action rather than to make repairs with absolutely no long-term benefit. Because Mr. Weitz was working with HUD, lenders, and engineers on a plan to make major repairs to the roof, Ms. Pelton contacted various roofing contractors to obtain suggestions for interim repairs that would provide good protection without having to provide a long-term warranty. The option selected by Mr. Weitz and Ms. Pelton was to install a new layer of shingles over the old, for which they received a bid of $65,000[130] from J & L Roofing.[131] The specifications for the bid included a 20-year warranty[132] for new shingles nailed over

[129]Ultimately, HUD denied the request to use the reserve funds, and a $25,000 adjustment was negotiated with the insurance company which had confirmed the wind damage. Tr. 923-25.

[130]In choosing this option, Mr. Weitz and Ms. Pelton considered the fact that the $13,000 previously requested from the reserve for replacements was to have been used to repair only a few buildings, while the $65,000 option would cover repair of all 19 buildings. Tr. 925.

[131]Mr. LaPierre was unable to find that J & L was licensed in the State of Maryland. *See* Tr. 885-87, 898-99. However, any negative inference from any lack of licensing is overcome by the weight of other evidence of competency. The company had done satisfactory work at Pemberton Manor during the preceding 18 years, as well as in connection with other HUD projects overseen by the Washington, D.C. and Richmond field offices. Tr. 1624-25. The company was responsive to requests for maintenance. Tr. 914, 928, 1625. Furthermore, Ms. Pelton had no reason to question whether J & L was licensed and carried all the necessary insurance because she had previously required proof of insurance and a permit. Tr. 928; R-9.

old; installing new flashing flanges on pipe collars, brown edging, new ridge vents, and

[132]Shingles that would last longer than intended were used because of quality, marginal cost difference, and uncertainty over the time it would take to finalize a long-term solution with HUD. Tr. 933-34.

continuous blocking; caulking walls; and guaranteeing workmanship for five years. R-9; Tr. 922-28, 1560-61, 1617.

164. On April 1, 1993, Mr. LaPierre conducted a physical inspection of Pemberton Manor.[133] Mr. Weitz was present. Mr. LaPierre did not climb onto the roofs. He observed that a new roof had not yet been installed, and he saw minor water stains on the ceilings of one or two top floor units. Mr. LaPierre prepared a physical inspection report which cited a "high urgency" need for maintenance on the roofs, flashing, and vents. Based upon the prior inspection reports and his own prior visits, Mr. LaPierre's report also stated that all repairs required by HUD had not been completed and that repair work was not on schedule. The comments to the report include the following statement:

> New roofs to be installed on all buildings, after all the existing shingles, flashing and vents have been removed. All sheathing must be inspected for deterioration and replaced if needed. All deteriorated wood trim at roof level must be replaced, then covered with aluminum, also damaged sections of gutters and downspouts must be replaced.

In Mr. LaPierre's opinion, the deficiencies with the shingles, flashing and vents could not be attributed to construction defects.[134] PI-10. *See also* Tr. 308, 874-80, 889, 898, 910.

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[133]The inspection was in connection with a comprehensive management review of Pemberton Manor conducted on March 19 and April 1, 1993. In a cover letter from Robert G. Iber, Chief of the Baltimore Office's Loan Management Branch to Mr. Weitz, dated April 30, 1993, Mr. Iber stated that the project's overall operation had been rated satisfactory. Mr. Iber further noted that although the physical inspection report rated the project satisfactory, several areas with a "highly urgent need for maintenance" existed, and "[t]he existence of these particular items is unsatisfactory." Accordingly, the letter concluded:

> In recognition of your beginning some repair work and the promised submission of a Management Improvement Operation Plan, the physical condition and maintenance policies are rated satisfactory. In your response to this review, please provide detailed explanations of corrective measures completed, planned or underway and specify target completion dates for any action planned.

PI-10.

[134]Mr. LaPierre's testimony that the deficiencies are not attributable to construction defects is suspect for two reasons. First, Mr. LaPierre testified that to come to such a conclusion, he would have to review the construction specifications, drawings and change orders. Yet, he admitted that his examination of the roof trusses was limited to noting Truss Plate Institute stamps and additional wall ties at the gable end walls. He had "no idea" why the additional ties had been installed, and he was unable to locate the buildings' plans. Tr. 901-03. Second, he acknowledged that during the April 1, 1993, meeting, everyone agreed that the roof would be "restructured," *i.e.*, "a whole new roofing system" would be installed. Tr. 893-94. Moreover, in a site visit report dated September 23, 1993, discussed *infra*, Mr. LaPierre acknowledged that part of the planned replacement of the roof at Pemberton Manor was to include "modification. . .to existing roof trusses." R-6. Thus, despite protestations to the contrary, he has acknowledged that construction related items needed to be addressed in order to resolve the deficiencies.

165. Also on April 1, 1993, Mr. Weitz met at Pemberton Manor with representatives of both HUD's Baltimore and Philadelphia offices, including Mr. Severe and Mr. LaPierre. The major issue was the roofs. According to Mr. Weitz, the meeting was "very pleasant, and we all seemed to want to cooperate with one another in resolving this long-standing issue." Mr. LaPierre "thought everything was going hunky-dory," and recalled "[w]e all wheeled and dealed and everybody left smiling." Tr. 308, 906, 1562-63.

166. In August 1993, the interim corrective plan was implemented to install new roof shingles over the old. The work was performed by J & L Roofing, pursuant to the bid specifications described above in Finding No.163. The total cost of the project was $65,000. A $25,000 insurance adjustment was applied to the cost.[135] The remaining $40,000 was paid out of surplus cash. The new roof has a good appearance and has performed well.[136] Tr. 925-28, 1561-62, 1617.

167. Mr. LaPierre conducted a site visit at Pemberton Manor on September 23, 1993. He had been asked by David Cohen, the HUD loan servicer for Pemberton Manor, to look at the new roof shingles that had been installed. During that visit, he did not leave his automobile, but viewed the roofs through his binoculars.[137] Mr. LaPierre

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[135] *See supra* n.129.

[136] Mr. Weitz acknowledged that a few new shingles blew off after the new layer was installed, but he attributed this to the fact they were installed at the end of the summer or in early-fall and had not had sufficient time to set. Tr. 1617. Mr. LaPierre acknowledged that even on roofs that are installed in the summer when the temperature helps the sealing process, some shingles may blowoff. Tr. 904-05.

[137] Mr. LaPierre's had not been up on the Pemberton Manor roofs since his inspection more than two years earlier. In criticizing mortgagee inspections, Mr. McSherry testified, "I don't think you want to know my opinion about these people who did these inspections. Most of them don't get out of their car." Tr.

observed that new shingles had been placed over old shingles.[138] He also observed that the new shingles had not properly sealed onto the old shingles, which were cupping; that roof cement had been used instead of replacing the flashing at the parapet walls; and that shingles had broken off and were on the ground.[139] Mr. LaPierre is of the opinion that placing new shingles over old was improper, that Mr. Weitz did not do what was necessary to repair the roof, and that Mr. Weitz had not done what had been agreed to

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848. *See also* Tr. 854.

[138]Mr. LaPierre was not aware of the scope of work performed in August 1993. He testified that he was mainly concerned with the parapet walls and the use of roof cement. Tr. 896-98.

[139]Ms. Pelton testified that approximately 11 shingles had come off, and that J & L came out promptly and replaced them. Tr. 928.

at the April 1 meeting. Accordingly, he noted in his report that "as usual Ben did it his way. . . ." R-6; Tr. 880-82, 887-88, 891-94, 896-97.

168. In March 1994, Mr. LaPierre again visited Pemberton Manor. Again, he did not leave his car, but used binoculars. He did not observe any shingles on the ground, but observed shingles that were lifting and not properly sealing. Tr. 887-88, 894-96, 898, 906.

169. In an April 22, 1994, physical inspection report prepared by Chemical Mortgage Company, the Pemberton Manor mortgagee, using HUD form 9822, the inspector rated Pemberton Manor's overall physical condition and maintenance policies and practices as "superior," and did not cite any maintenance deficiencies with the roof system. The comments to the report noted that all 19 buildings had been reshingled. R-8.

170. By letter dated January 11, 1994, Mr. Weitz submitted to Mr. Severe plans for various repairs and improvements at Pemberton Manor, including plans for replacement of the roof surfaces and repair of the gable end trusses. In the letter, Mr. Weitz stated:

> Once HUD has reviewed and furnished their written comments on the concept plans, we can then move on finalizing the analyses, working drawings and specifications and then, with HUD's prior written approval, bidding the work to general contractors. Will prevailing wage requirements apply? What other HUD requirements should be anticipated pursuant to the 241 loan program?
>
> As previously mentioned, approval of funding from the Reserve Fund for Replacement for payment of the up front professional services must be agreed to by HUD in writing before we can proceed. Your prompt written reply would be deeply appreciated.

R-7. *See also* Tr. 929, 1563.

171. On or about May 15, 1994, Mr. LaPierre reviewed Mr. Weitz' proposal, and reported to Robert G. Iber,[140] Chief of the Baltimore Office's Loan Management Branch,

[140]Although Mr. Iber was listed by the Government as a potential witness concerning the physical condition of Pemberton Manor, as well as "HUD requirements concerning the project within the Baltimore Office's jurisdiction, the audit resolution process, [and] the allegations concerning the operating loss loan for Pemberton Manor," he was not called to testify at the hearing. *See* Government's List of Witnesses

that he had no objection to proceeding with the proposal insofar as it concerned

(March 15, 1994).

the roof. As of the hearing, Mr. LaPierre was unaware of the status of HUD's review of the proposal. Tr. 894-96, 906.

172. By letter dated May 20, 1994, Mr. Iber advised Mr. Weitz that HUD could not approve withdrawal of certain architectural fees from the reserve for replacement account as requested in the January 11, 1994, letter, but that such fees could be included in a Section 241 loan. Mr. Iber further noted that the reviewing engineer had questioned certain items on engineering and architectural drawings, particularly with regard to the HVAC system. He also required further documentation to discuss those concerns as they related to approval of the proposal, which would serve as the basis to increase rents. Mr. Iber further stated that if an application for a Section 241 loan were submitted, Mr. Weitz would have to receive HUD 2530 clearance from the Previous Participation Branch before the loan application could be processed. Having been advised by Rick Young of HUD Headquarters that as long as the RIGA Audit remained outstanding, he could not receive clearance, it was Mr. Weitz' understanding that he could also not receive such clearance as long as the LDP and debarment proceedings were pending. R-30; Tr. 1563-65, 1617-18.

Count V: The Alleged Improper Distribution of $223,965 in Essex House Project Funds While High Urgency Maintenance Items Were Outstanding

173. Paragraph 6(e)(4) of the Regulatory Agreement for Essex House states:

> 6. Owners shall not without the prior written approval of the Commissioner:
>
> * * *
>
> (e) Make, or receive and retain, any distribution of assets or any income of any kind of the project, except from surplus cash and except on the following conditions:
>
> * * *
>
> (4) There shall have been compliance with all outstanding notices of requirements for proper maintenance of the project.

AR-4B, ¶ 6(e)(4).

174. Paragraph 11 of the Regulatory Agreement for Essex House states that:

> Upon violation of any of the above provisions of this Agreement by Owners, the Commissioner may give written notice, thereof, to Owners, by registered or certified mail . . . If such violation is not corrected to the satisfaction of the Commissioner within thirty days after the date such notice is mailed or within such further time as

> the Commissioner reasonably determines is necessary to correct the violation, without further notice the Commissioner may declare a default under this Agreement effective on the date of such declaration of default. . . .

AR-4B, ¶ 11.[141]

175. Mr. Ransom's June 14, 1989, physical inspection report of Essex House cited a "high urgency" need for maintenance on the "roofs, flashing, vents," the "drives, parking lots, paving, curbs," the "elevators," and the "fire extinguishers." The comments to the report stated: "[n]eed to replace roof and all flashings at parapet walls," "[n]eed potholes in asphalt patched and hair line cracks sealed," "[e]levator doors need replacing as well as the control panels on walls at elevators[; n]eed flush mount type," and "[t]here are no extinguishers in cases[; w]ould recommend the use of individual unit extinguishers.[142] PI-1.

176. By letter dated July 11, 1989, Mr. Hill, Chief of the D.C. Field Office's Loan Management Branch, forwarded Mr. Ransom's physical inspection report to Mr. Weitz. The letter stated, *inter alia*, that Mr. Weitz was to provide HUD with a property improvement plan by July 31, 1989, to correct the high and medium urgency deficiencies. The letter did not state any consequence for failing to abide by its terms, including any reference to allowable distributions of surplus cash.[143] PI-1.

177. The Essex House financial statement for the year ending September 30, 1990, showed cash outflows of $223,965 as follows: $212,033, designated as "reduction of advances to general partners;" $5,932, designated as "payment of accrued interest, general partner;" and $6,000, designated as "administrative fees paid to

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[141] According to Mr. Severe, notice of "high urgency" deficiencies to an owner can be made by issuance of the inspection report, a letter, or a phone call. However, he acknowledged that he was unaware of the requirements in paragraph 11 of the Regulatory Agreement. Tr. 326-27.

[142] *See supra* Finding No. 139 for further details of the report's contents.

[143] *See supra* Finding No.139 for further details of the letter's contents.

general partner."[144] JE-EH-1990 at 7.

178. At the time the September 30, 1990, financial statement for Essex House was filed with HUD, Ms. Heyde, the loan servicer for Essex House, did not check the

[144] *See supra* Finding Nos.120, 122. These amounts are also the subject of Count III.

most recent physical inspection report for high urgency deficiency items in connection with any determination whether surplus cash had been distributed.[145] Tr. 774.

179. The April 1991, RIGA Audit Report cited "distribution" of the $223,965 as a violation of Paragraph 6(e)(4) of the Essex House Regulatory Agreement. The Report, referring to the June 14, 1989, and November 14, 1990, inspections, noted that four "high urgency" repairs -- replacing the roofs and flashing, patching potholes, replacing elevator doors and control panels, and installing fire extinguishers -- had not been corrected. It also noted Mr. Weitz' representation that "he had contacted HUD to arrange a plan for rectifying the cited deficiencies, [but that] HUD did not respond." The Report acknowledged Mr. Weitz' claim that "the distributions were eligible and proper because surplus cash was available to make the payments," but it stated that he "failed to provide accounting records necessary to validate whether the project was in a surplus cash position." The Report concluded:

> The Agent/Owner was required to correct the cited repair items before any distributions were made. Therefore, we consider the distributions ineligible.

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[145]Ms. Heyde testified that on "at least on one other occasion" she had questioned or disallowed a distribution based on an outstanding notice of need for repair. However, that incident could not have pre-dated the Audit Report in this case because she only recently began to check maintenance deficiency items against distributions. Tr. 744, 746.

AR-1 at 3-4.[146]

[146]There is no evidence that a formal HUD policy supported the conclusion reached in the Audit Report. Mr. Severe could not recall any situation other than the one involving Mr. Weitz in which a notation in an inspection report was considered to constitute the type of notice required to preclude a distribution. He also acknowledged that he was not familiar with any handbook, issuance, or training curriculum which states that no distribution may be made when outstanding "high urgency" maintenance items are noted on an inspection report. He further acknowledged that he did not know whether, in fact, loan servicers uniformly review financial statements to determine if distributions have been made despite the notation of outstanding high-urgency deficiencies, and if so, whether they require repayment of monies so distributed. At a minimum, Ms. Heyde did not make such a determination during the relevant period when she was the loan servicer responsible for Essex House. Moreover, other than her reference to a "little booklet" which refers to open IG findings that have not been corrected, she could not recall any written guideline relating to physical inspections. Without any indication that HUD had acted pursuant to an established policy, Ms. Mitrovitch recalled one instance involving multiple properties, that occurred sometime prior to June 1989, where the HUD Columbia, South Carolina office (not within the jurisdiction of Region III) informed the owner that, based upon a failure to comply with outstanding maintenance requirements, it would not permit distributions. Mr. Miles, Ms. Mitrovitch's predecessor in the Richmond office, testified that it is not "automatic" for a high urgency item on a physical inspection report to result in HUD telling an owner that it cannot make distributions of surplus cash. Rather, "it would be something that would be set down and talked to the owner about." Tr. 307, 322-27, 399, 457-58, 496, 553-54, 746, 772-74.

180. The first time Ms. Heyde learned of the $223,965 distribution was shortly after the RIGA's Audit Report was issued in April 1991.[147] Ms. Heyde never reviewed any documentation supporting the RIGA's finding; rather she took the finding on faith, since the RIGA had spent months preparing its report. Tr. 744-45, 774-76, 780-82.

181. During audit resolution with Mr. Weitz, Mr. Severe's office recommended that the audit finding of the improper distribution be closed.[148] The RIGA's office responded that it "would close the finding when the roofs had been repaired. . . ." Mr. Severe's office "did not view that as an unreasonable response" and did not appeal the RIGA's decision to HUD Headquarters.[149] Tr. 333-36.

182. Specifications for replacement of the Essex House roof have been

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[147]Ms. Heyde testified that she did not recall whether she had received the financial statement for the year ending September 30, 1990, prior to first seeing the Audit Report in April 1991. However, she acknowledged that the financial statement would have been due within 60 days of September 30, 1990, *i.e.*, November 30, 1990. No allegation has been made by the Government that the financial statements were not timely filed. *See* Tr. 774-76.

[148]As discussed *supra*, the Regional Office prepared responses to the Audit, while the field offices' involvement was limited to providing information to the Regional Office. *See, e.g.*, Tr. 780-82.

[149]Mr. Severe testified that from 1991 through at least mid-April 1994, the RIGA's determination could have been appealed to HUD Headquarters. However, he acknowledged that he was unaware that any such appeal had ever been taken during that time. Tr. 333-35.

approved by HUD and have been sent out for bid. At the time of the hearing, it was anticipated that work would begin during the summer of 1994 and be completed during the fall or early winter of 1995. *See* Finding No. 155, *citing* Tr. 821-24, 853, 920-21, 931-33, 1551-52. As of the hearing, the potholes had been patched[150] and the elevator doors and control panels[151] had been replaced.[152] Consistent with the policy of the City of Alexandria

[150]The record demonstrates that the pothole repairs were made sometime between Mr. Fisher's August 21, 1991, inspection and Ms. Heyde's and Mr. McSherry's December 3, 1992, inspection. *See* PI-2; PI-3.

[151]The City of Alexandria, Virginia, inspected the elevators more than once each year. The City never indicated that there was a safety problem with the Essex House elevators. Tr. 1569-70.

[152]In the Spring of 1990, Mr. Weitz requested use of the reserve fund for replacements to repair the elevators. In late 1990 or early 1991, HUD approved the request, and the work was completed during 1991. PI-2; PI-3; Tr. 1568-69.

Fire Department, fire extinguishers had been removed after having been vandalized.[153] RX-31; PI-2; PI-3; Tr. 1568-71.

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[153]The record demonstrates that since at least August 21, 1991, HUD has been provided with a confirmable explanation for the lack of certain fire extinguishers at Essex House, and that in December 1992, the matter was no longer one of significance to the Essex House loan servicer. Although Mr. Fisher recorded a "high urgency" need for maintenance of the fire extinguishers in his August 21, 1991, inspection report, he noted that "there needs to be an understanding between HUD and the Fire Dept because [City of] Alex [sic] reportedly agreed to removal of hall fire extinguishers . . . ." PI-2. The policy of the City of Alexandria Fire Department is set forth in a letter from the Chief Fire Marshall to the Resident Manager of Essex House, which states:

> The policy of this department regarding fire extinguishers in residential hallways has been that these extinguishers may be removed at the discretion of the building owner or manager. The presence of extinguishers in these areas has, in the past, created problems. Building occupants tend to target these devices in acts of vandalism or theft. When an actual fire occurs; [sic] experience has shown that; [sic] tenants will often use the extinguishers first and significantly delay an alarm of fire. This has resulted in increased fire losses. Besides, untrained persons using extinguishers are more likely to incur injuries. This is due to the improper use of these devices. The occupant would be safer if they [sic] had evacuated the building upon the initial discovery of a fire and promptly notified the Fire Department.

R-31. The letter further stated that fire extinguishers are "mandated in areas only accessible by your staff." These areas included, but were not limited to, "boiler rooms, electric rooms, shop areas, etc." *Id*. The D.C. Field Office apparently chose not to pursue the matter, as Ms. Heyde did not mark fire extinguishers as an item needing maintenance in her December 3, 1992, inspection report. PI-3.

Discussion

The purpose of debarment is to protect the public interest by precluding persons who are not "responsible" from conducting business with the Federal government. 24 C.F.R. § 24.115(a). *See also Agan v. Pierce*, 576 F. Supp. 257, 261 (N.D. Ga. 1983); *Stanko Packing Co., Inc. v. Bergland*, 489 F. Supp. 947, 948-49 (D.D.C. 1980). The debarment process is not intended to punish; rather, it is designed to protect governmental interests not safeguarded by other laws. *Joseph Constr. Co. v. Veterans Admin.*, 595 F. Supp. 448, 452 (N.D. Ill. 1984). In other words, the purpose of debarment is remedial, not punitive. *See* 24 C.F.R. § 24.115.

In the context of debarment proceedings, "responsibility is a term of art that encompasses integrity, honesty, and the general ability to conduct business lawfully. *See* 24 C.F.R. § 24.305; *Gonzalez v. Freeman*, 334 F.2d 570, 573 & n.4, 576-77 (D.C. Cir. 1964). Determining "responsibility" requires an assessment of the current risk that the government will be injured in the future by doing business with a respondent. *See Shane Meat Co., Inc. v. U.S. Dep't of Defense*, 800 F.2d 334, 338 (3d Cir. 1986). That

assessment may be based on past acts. *See Agan*, 576 F. Supp. 257; *Delta Rocky Mountain Petroleum, Inc. v. U.S. Dep't of Defense*, 726 F. Supp. 278 (D. Colo. 1989).

1. **Mr. Weitz and His Named Affiliate Are Subject to HUD's Debarment Regulations, 24 C.F.R. Part 24**

As the managing general partner of the limited partnerships that own the Projects and as the President of CHRC, Mr. Weitz is considered a "participant" and "principal" in "covered transactions." *See* 24 C.F.R. §§ 24.105(m) and (p), 24.110(a)(1). Mr. Weitz is therefore subject to HUD's regulations governing debarment. As already determined, CHRC is an "affiliate" of Mr. Weitz, and is therefore also subject to the debarment regulations. *See* Initial Determination of Affiliation, HUDALJ 94-0009-DB (June 3, 1994); 24 C.F.R. §§ 24.105(b), 24.710(c).

2. **The Government Has Failed to Demonstrate that Cause Exists to Debar Respondents**

The Government alleges that as to all five counts, cause exists to debar Respondents under 24 C.F.R. §§ 24.305(b), (d) and (f). Those provisions state:

> (b) Violation of the terms of a public agreement or transaction so serious as to affect the integrity of an agency program, such as:
>
> (1) A willful failure to perform in accordance with the terms of one or more public agreements or transactions;
>
> (2) A history of failure to perform or of unsatisfactory performance of one or more public agreements or transactions; or
>
> (3) A willful violation of a statutory or regulatory provision or requirement applicable to a public agreement or transaction.
>
> * * *
>
> (d) Any other cause of so serious or compelling a nature that it affects the present responsibility of a person.
>
> * * *
>
> (f) In addition to the causes set forth above, HUD may debar a person from participating in any programs or activities of the Department for material violation of a statutory or regulatory provision or program requirement applicable to a public agreement or transaction including applications for grants, financial assistance, insurance or guarantees, or to the

> performance of requirements under a grant, assistance award or conditional or final commitment to insure or guarantee.

24 C.F.R. §§ 24.305(b), (d) and (f). Cause for debarment must be established by "a preponderance of the evidence." *Id*. at § 24.313(b)(3). "Preponderance of the evidence" is defined as "[p]roof by information that, compared with that opposing it, leads to the conclusion that the fact at issue is more probably true than not." *Id*. at § 24.105(o). The Department has the burden of proving cause.[154] *Id*. at § 24.313(b)(4).

A. The Government Has Not Demonstrated that Respondents Made Unauthorized Distributions of Nearly $1.2 Million of Project Funds

Count I of the Complaint alleges that Mr. Weitz made or directed to be made unauthorized "distributions" from the operating accounts of the Projects in the amount of almost $1.2 million for "non-operating advances." The pertinent Regulatory Agreements allowed the Projects to repay advances for reasonable expenses incident to the operation and maintenance of the Projects, provided the Projects were not in financial jeopardy.[155] Such repayments were not, at that time, considered "distributions" within

[154]A respondent, on the other hand, has the burden of establishing any mitigating circumstances. 24 C.F.R. §§ 24.313(b)(3) and (4). Moreover, the mere existence of a cause for debarment does not necessarily mandate that an individual be debarred. The sanction is a discretionary one that requires consideration of the seriousness of a respondent's acts or omissions, as well as any evidence of mitigation.
24 C.F.R. §§ 24.115(d) and 24.300; *see also Agan,* 576 F. Supp. at 260-61.

[155]Contrary to the position taken by the Government, the Regulatory Agreement provisions requiring that an owner obtain prior written HUD approval before "encumbering" the property are not applicable to

the meaning of the Regulatory Agreements. Because there is not a scintilla of evidence that the Projects were ever in financial jeopardy,[156] for the Government to demonstrate cause under Count I, it must show that operating losses were *not* incurred, funds were *not* advanced by the general partners to cover those losses, and that, therefore, any repayments of purported advances were *in actuality* unauthorized distributions.

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the operating advances made by the general partners. By their express terms, the Regulatory Agreements exempt operating advances from such a requirement. *See* Finding No. 76. Moreover, the operating advances are not "encumbrances." They are personal debts, *i.e.*, they do not affect the title or physical condition of land, as the cases the government cites make clear. See 20 Am Jur 2d Covenants § 85; *Bergstrom v. Moore*, 677 P.2d 1123 (Utah 1984).

[156]Government Counsel acknowledged in his opening statement that the Projects are generally in good condition and the mortgages are current. This admission is not inconsistent with the Government's theory that any improper distribution, regardless how small, threatens the financial security of a Project because any distribution reduces the amount of money available to make repairs and pay the mortgage and, therefore, might necessitate a rent increase. Tr. 13-17. Because, as discussed *infra*, no "improper distributions" have been shown I need not address the merit of the Government's theory.

The Government's case in Count I rests on evidence prepared and submitted by Regional Comptroller Ward. Although the Government retained a nationally known accounting firm and identified representatives of the firm as prospective witnesses, those witnesses were never called to testify, leaving Mr. Ward's evidence standing alone and uncorroborated.[157] Unable to substantiate the findings in his report, the Government has attempted to shift the burden of proof to Mr. Weitz, calling upon him to prove that the conclusions in Mr. Ward's Report are incorrect. However, the burden of proof established by the Department's own regulations requires that the Government prove Mr. Ward's conclusions correct.

By his own admission, Mr. Ward prepared his evidence relying on restatements of surplus cash and restated balance sheets prepared by Ms. Flaherty, Mr. Weitz' current accountant. However those restatements did not and could not guarantee that the figures contained therein fully and accurately represented the financial condition of the projects at any time during their history. The restatements were prepared only in response to an issue raised in the 1991 Audit Report, and were intended to be a starting point for further discussion and analysis. Indeed, the Government itself undermined the credibility of Mr. Ward's evidence by attacking the accuracy of the restatements during cross-examination.

Even according to other Government witnesses, Mr. Ward should have based his analysis on a complete set of the projects' annual audited financial statements going back to inception. Those financial statements had been regularly filed with HUD shortly after preparation and had never been questioned by HUD as to their accuracy or probity. Furthermore, Mr. Ward failed to consult with, or review the workpapers of, the original accountants who prepared the certified annual financial statements. He also failed to comprehend that entries made in ledgers and year-end financial statements are subject to adjustment if independent public accountants later determine that economic reality, which could not have been known with certainty during the actual accounting period, requires that an entry be reclassified. A HUD Handbook[158] recognizes that IPAs

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[157]Since it can be assumed from the notice of intent to call these witnesses that the Government intended to elicit from them material, noncumulative evidence to advance its case, it is appropriate to infer from its failure to call them or to offer an explanation for their absence, that those witnesses were unable to corroborate Mr. Ward's Report and related testimony. *See United States v. Mahone*, 537 F.2d 922 (7th Cir.), *cert. denied*, 429 U.S. 1025 (1976); *Feldstein v. Harrington*, 90 N.W.2d 566 (Wis. 1960).

[158]*See* Finding No. 83, *citing* R-11 (IG 4372.1), ¶ 8(d).

must make such judgments when they determine what are reasonable and necessary operating expenses. His failure properly to assess and accomplish his analysis can, at best, be attributed to his lack of familiarity with HUD programs and his misguided notion that Mr. Weitz should provide documents that HUD neither questioned nor retained.

Respondent's expert witness, Ronald M. Kohl, demonstrated that Mr. Ward's analysis was poorly conceived and his conclusions fallacious. Mr. Kohl, a certified public accountant and partner with a large St. Louis, Missouri, firm, had extensive experience in auditing projects similar to those involved in this proceeding, and he had no pecuniary interest in the outcome of this case.[159] Tr. 1337-1344. Based on his review of all financial statements, cost certifications, syndication documents, and partnership agreements, together with various correspondence, the Complaint, and, most significantly, Mr. Ward's Report itself, Mr. Kohl concluded that Mr. Ward did not understand how the Projects worked nor had he considered all appropriate documentation.[160] As a result, Mr. Kohl found the Report to be "incorrect," "unsupportable," "misleading," and "unprofessional."[161] Tr. 1343-1347, 1398.

Mr. Kohl's analysis of the Projects' financial statements illustrated the implausibility of Mr. Ward's findings.[162] Although Mr. Ward asserts that over $3.5 million in cash was generated and distributed from the Projects' operations, Mr. Kohl demonstrated that only slightly in excess of $2 million had been generated by their operations.[163] Although Mr. Ward concluded that Mr. Weitz should repay the Projects nearly $1.2 million, Mr. Kohl demonstrated that the Projects generated only $138,000 in excess of distributions allowed to be paid out during the relevant period. In other words, Mr. Ward would have Respondents repay the Projects an amount that is nine times the amount generated by the Projects in excess of permitted distributions. Mr. Kohl demonstrated that Mr. Ward's finding that $1.6 million should be deposited into residual receipts is similarly flawed. The sum of the amount Mr. Ward concluded should be paid back to the Projects ($1.2 million) plus the amount he concluded should be deposited into residual receipts ($1.6 million) far exceeds the total amount of cash generated by the Projects ($2,021,000). Finally, Mr. Kohl demonstrated that $700,000 of the funds Mr. Ward concluded had been improperly paid out from Royal Arms, Essex House, and Pemberton Manor alone were really payments out of non-project revenues over which

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[159]Shortly after the hearing, Mr. Kohl died. *See* Motion to Strike Government's Exhibit GPHE-1 (July 25, 1994).

[160]Mr. Kohl's testimony was also consistent with findings in this Initial Determination that a promissory note is not required to evidence an operating advance, that only since 1992 has HUD restricted the repayment of operating advances from surplus cash, and that there is nothing which prohibits the payment of interest on an operating advance, which is a typical project expense. Tr. 1367-69, 1380-81, 1430-34.

[161]The most Mr. Kohl could say about Mr. Ward's Report was that "[i]t's a neat example of Lotus spreadsheets. . . ." Tr. 1348.

[162]Mr. Kohl attributed the errors made by Mr. Ward to, *inter alia*, use of incorrect cost cutoff dates, a failure to distinguish between project and nonproject funds, and a failure to acknowledge the proper allocation of funds by utilizing adjusting journal entries. *See, e.g.*, Tr. 1350-54, 1363-65, 1370-80, 1412.

[163]Mr. Kohl's calculation did not take into consideration deductions for interest. Had he done so, the total figure would have been even *lower*. Tr. 1403-04.

HUD exercised no control. Mr. Ward reached his conclusions by looking only at gross distributions and by ignoring the source of incoming funds, such as capital contributions. For example, as Mr. Kohl pointed out, had a $1 million capital contribution been deposited and then immediately used to pay development fees, Mr. Ward would have concluded that Mr. Weitz had to repay that $1 million as well. R-19;[164] Tr. 1349-65, 1381-89, 1405-07.

[164]R-19 is a chart prepared by Mr. Kohl setting forth his "Analysis of Cash Generated from Inception of Operations Period Ended From Cut Off Date to September 30, 1990." In an attempt to refute the information set forth in R-19 and Mr. Kohl's related hearing testimony, the Government attempted to introduce, GPHE-1, "Correction of Exhibit R-19," as an exhibit to its Post-Hearing Brief. By Order dated July 27, 1994, I granted a Motion to Strike GPHE-1 that had been filed by Respondents on July 25, 1994. In so ruling, I found, *inter alia*, that there was no foundation for the exhibit, it was too late for cross-examination on the exhibit, the author of R-19 was unavailable to reply to the exhibit, and the exhibit contained "partial" and "probable" explanations.

In an effort to bolster Mr. Ward's analysis, the Government resorted to impugning the professionalism and integrity of Mr. Weitz and his accountants. The Government has threatened to initiate disciplinary proceedings against the accountants before their professional organizations and, most seriously, has accused Mr. Weitz and his accountants of a massive conspiracy to create "bogus loans" and evade taxes.[165] There is no evidence whatever to substantiate that charge. Because the projects incurred operating losses, particularly in the start-up years, the general partners, consistent with their obligations under the applicable partnership agreements, advanced, that is, "loaned," operating funds to the projects. Those advances were properly reflected on the certified annual financial statements of the projects. They were not "bogus." Furthermore, no "project funds," as that term is employed by HUD, were used to repay non-operating advances made by the general partners. Finally, there is no evidence that any accountant violated a code of professional responsibility, and the record does not even suggest, let alone prove, a motive to explain why three different accounting entities would engage in an unlawful conspiracy.[166]

The record is devoid of any evidence upon which to conclude that cause for debarment exists under Count I. The evidence presented by the Government, especially in light of the testimony of Mr. Weitz' past and current independent accountants, which was corroborated by his expert witness, is unreliable, untrustworthy, and incredible.

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[165]Compounding these accusations, Mr. Ward gratuitously testified that he was told by one of Mr. Weitz' former accountants that their firm refused to continue to do business with Mr. Weitz because members of the firm "weren't willing to do the kinds of things anymore that he wanted them to do." The allegation was flatly and credibly denied by three members of the firm, including the alleged maker of the statement, in testimony untainted by any financial interest in the outcome of this proceeding. The Government attorney present when the statement was allegedly made did not offer to take the stand to corroborate Mr. Ward's accusation. *See supra* Finding No. 47, n.53.

[166]The integrity of Mr. Resnick's firm was illustrated when Mr. Resnick candidly admitted on cross-examination that his firm had, in fact, made an error in a financial statement. The error benefited the Project, not Respondents. *See* Tr. 1013-20, 1034-39. Apparently, HUD itself has found Mr. Resnick to be a man of integrity since it has retained his firm to review annual financial statements. Tr. 949, 987-88.

B. The Government Has Not Demonstrated that Respondents Improperly Procured and Used an Operating Loss Loan

Count II alleges the misuse of an operating loss loan that the Pemberton Manor partnership obtained from HUD in 1978. The loan, its use, and the modification of the Pemberton Manor mortgage had never been questioned by any official of HUD or FNMA, until a July 1993 meeting that Mr. Ward had with Mr. Weitz and his accountant. In his opening statement, Government counsel charged that the loan was "obtained by false pretenses or not used for its intended purpose," that it was used to repay development fees, and that it violated a regulatory provision prohibiting distributions by the projects from borrowed funds.

The National Housing Act authorizes insurance of a supplemental loan to cover the loss experienced by a mortgagor of a multifamily project during the first two years of the project's operation. *See* Finding No. 96, *citing* 12 U.S.C. § 1715n(d). A HUD Handbook refers to this "two year operating loss" and notes that "recoupment" is limited to the amount certain disbursements and expenses for maintenance and operations exceed income. *See* Finding No. 97, *citing* R-26 (RHM 4350.1 Supp. 1, Ch. 4, § 16, ¶ (1)(a)). The plain meaning of "recoupment" is reimbursement of funds *expended*.

The audited financial statements filed with HUD show that during the first 16 months of operation that began in October 1975, the Pemberton Manor project incurred losses from operations of $329,638. In August 1978, after making its own calculations, HUD issued a commitment to insure an operating loss loan in the amount of $292,500. Notwithstanding that the commitment approximated the amount finally requested by Mr. Weitz, the Government alleges, on the basis of fragmentary evidence, that he induced HUD to insure a loan that would be used in part to fund construction deficiencies at the project -- that is, that HUD insured an "operating loss loan" used to fund something other than operating losses.

Although the Government listed witnesses from the Housing Management Division of HUD which approved the loan, FNMA which approved a mortgage modification, and CMC which applied for the modification, the only witness actually called to testify was Mr. Ward. He questioned the Operating Loss Loan because a document pertaining to the original request for a larger loan stated an intent to escrow a portion of the funds to correct construction deficiencies.[167] Other documents concerning a related mortgage modification, chiefly involving FNMA and CMC, referred to use of the operating loss loan proceeds to make repairs. However, the trail of documents referring to construction deficiencies ended in February 1978, some six months before the final commitment was issued by HUD. The final commitment in the amount of $292,500, expressly stated that it constituted "the entire agreement" between the parties. It contained 15 conditions, none of which addressed construction

[167] HUD denied this original loan application.

deficiencies.[168] Moreover, in issuing its own firm commitment to make the loan in the amount of $292,500, the mortgagee made no reference to repair of construction defects and stated that any requirements imposed by FHA were incorporated into its commitment. No cited Handbook, statute, or regulatory provision contains any directions for, or restrictions on, the use of loan proceeds. Accordingly, there is no evidence that any official was induced to take any action with regard to the loan on the basis of a commitment to use the proceeds for any reason other than to reimburse operating losses.

Mr. Ward also took issue with two reclassifications in Pemberton Manor ledgers which he believes resulted in inflated operating losses that were used to justify the request for the loan. Respondents presented evidence that the reclassifications were proper allocations between operating advances and development fees. The validity of Mr. Ward's concern cannot be determined because there was no testimony from those who made the reclassifications some 17 years ago, and not all the workpapers have been found. Accordingly, the Government has failed to prove that the reclassifications were improper.

[168]HUD's own regulations expressly incorporate the principle that the firm commitment sets forth the terms and conditionns upon which the mortgage is insured. *See* Finding No. 110, *citing* 24 C.F.R. § 221.509(a)(3).

Finally, the Government alleges that use of the loan proceeds to reimburse CHRC for operating advances constituted a distribution by the project from borrowed funds. However, the advances were made by CHRC, they covered the operating losses incurred by the projects, and the loan was applied for by CHRC. The proceeds were issued to the limited partnership, which in turn endorsed the checks over to CHRC. Accordingly, there is no evidence that any project funds, rather than partnership funds, were distributed.[169]

[169]Because only partnership funds were involved, there is no merit to the Government's argument that there was a violation of the HUD Handbook provision which prohibits withdrawals of *project* funds to reimburse owners for prior advances while the mortgage is under modification without prior written approval from HUD. *See* Finding No. 83, *citing* R-11, ¶ 8(d) (IG 4372.1). Even had the funds belonged to the Project, it is illogical to argue, as does the Government, that the cited Handbook provision was not complied with when HUD approved the OLL, knowing that the mortgage was under modification. The very purpose of an OLL was to reimburse owners for advances to cover operating deficits.

There is no evidence upon which to conclude that cause for debarment exists under Count II. The evidence presented by the Government is fragmentary and only tied together with unwarranted inferences.

C. The Government Has Not Demonstrated that Respondents Improperly Paid a $212,033 Note Payable

Count III alleges that Mr. Weitz improperly "paid himself a 'note payable' in the amount of $212,033 from project funds of the Essex House project." This is another allegation that arose from Mr. Ward's analysis of certain financial statements, not from the Regional Inspector General's 1991 Audit Report.

The note itself evidences a non-interest bearing debt incurred in 1975 that was owed to CHRC for development fees by the limited partnership that owned Essex House. It had been paid down in 1983 to $212,033. Having found himself engaged in what has been described by one HUD loan analyst as a long "paper war" over rent increases to help fund roof repairs at Essex House (Counts IV and V, *infra*), Mr. Weitz ordered Mr. Shah, an employee of CMC, to close certain reserve accounts and to pay off outstanding operating advances. Mr. Shah was not called to testify at the hearing, and there is no evidence upon which I could conclude that he was directed to consider this particular obligation an operating advance and to pay it off. I credit the testimony of both Mr. Weitz and Ms. Flaherty that Mr. Shah erroneously read a financial statement and concluded that the $212,033 represented the balance owed on an operating loan. As a result, in April 1990, Mr. Shah paid that amount plus interest out of an Essex House project account into an account of CHRC. The facts surrounding the payment of the note cannot be stated more definitively, yet the Government, on brief, complains that Mr. Weitz "has yet to fully explain what has happened to the $212,033." However, the burden to prove cause for debarment is on the Government, not Respondents. The record contains no evidence that Mr. Weitz directed or otherwise acquiesced in payment of the note knowing that it represented a development fee payable.

In the summer of 1991, Ms. Flaherty discovered that the obligation had been recorded as a note payable, rather than as a development fee payable. Because a development fee may not be paid out of surplus cash, and because the development fee is an obligation of the limited partnership, not of the project, Mr. Weitz and Ms. Flaherty determined a way to rectify the error. A portion of funds that had been invested by CHRC in a financial asset were assigned to the limited partnership. That portion corresponded to the amount due back from CHRC to the limited partnership, plus interest. When the funds became available, that amount was paid over to the limited partnership. A corresponding credit to the project was made by reducing the amount of limited distributions payable to the limited partnership by the project.
The financial statements for the Project and the partnership for 1991 and 1992 reflect the corrective measures taken.

Having considered the record evidence, I cannot conclude that the payment of

the note from the Project was anything other than a result of an error that was discovered by Respondents and has since been voluntarily corrected by them. Accordingly, I cannot conclude that that cause for debarment exists under Count III.

D. The Government Has Not Demonstrated that Respondents Failed to Properly Maintain Essex House and Pemberton Manor

Count IV alleges that Respondents failed to properly maintain the roof systems at two of the projects, Essex House and Pemberton Manor. In 1983,[170] Mr. Weitz unsuccessfully sought loans to finance the repair and replacement of roofs at the two projects. Although HUD approved an application for a loan in the amount of $800,000 that would, *inter alia*, cover replacement of the roof system at Essex House, the funds were not borrowed because the partnership did not want to accept a condition that restricted use of the project as low-income housing for an additional 55 years. The State of Maryland approved a loan of $1,350,000 to correct the roofs at Pemberton Manor and to change the heating, ventilating, and air-conditioning system. Mr. Weitz has yet to hear from HUD on its approval of this 1983 application.

In 1988, HUD turned down a proposal to finance the cost of renovating the roofs at Pemberton Manor because approval would result in a rent increase that it found higher than reasonable and beyond the tenants' ability to pay. In 1989, Mr. Weitz requested a rent increase at Essex House that would cover the cost of debt service on an $800,000 loan that would be used, *inter alia*, to replace the roof and to repair the parapet wall around the roof. A HUD physical inspection report, used to evaluate the rent increase request and related loan proposal, found the property to be in "satisfactory" condition, and the maintenance and policy procedures to be "superior." The report noted a "high urgency" need for maintenance on the roof, flashing, and vents, and that the roof and all flashing at the parapet wall needed to be replaced. The report closed with a recommendation that a new roof system be installed. However, a "paper war" ensued over information required of Mr. Weitz to support the proposed rent increase. In the words of Ms. Heyde, the HUD loan analyst, when Mr. Weitz chose to opt out of Section 8 contracts and sued the Secretary of HUD, the war got "very heated up and not a pleasant situation." HUD rejected the rent increase request.

To provide an additional source of funds for repairs and improvements beyond the regular reserve fund for replacements, Mr. Weitz had established additional reserve accounts that were funded by surplus cash. Because his requests for rent increases to cover repair and replacement of roofs were denied in light of the accumulation of funds in the supplementary reserve accounts, Mr. Weitz decided to close those accounts in April 1990. *See supra* Count I, Finding No. 94. Closure of those accounts raised, for

[170]As discussed *supra* in Count III, Respondents had applied to HUD in March 1977 for an OLL, a portion of which was to have been placed in escrow for the correction of construction defects at Pemberton Manor. That application was denied.

the first time, questions concerning the propriety of the accounts and their funding. The RIGA audit began in August. *See supra* Background, Finding No. 8.

In January 1991, Mr. Weitz obtained approval from HUD for a rent increase at Essex House that was calculated to include a ten-fold increase in the reserve fund for replacements. He intended to use the increase in the reserve fund to replace the roof system. An August 1991 HUD physical inspection report rated the overall condition of the building, as well as the maintenance policies and practices, as "satisfactory." The report also noted that the roof needed complete replacement and that there was a "high urgency" need for maintenance on the roof, flashing, and vents. A mortgagee inspection in November 1992 also found conditions to be "satisfactory," and noted that upon completion of painting and carpeting projects, "the property could easily earn a superior evaluation."

In preparation for the December 1992 LDP conference in Philadelphia, Mr. McSherry, a HUD construction analyst, inspected Essex House. He found great progress on small dollar items, but virtually no action on major deficiencies, which included the roof. He concluded that the roof was in need of total replacement, and a physical inspection report was prepared citing a "high urgency" need for, *inter alia*, maintenance on the roofs, flashing and vents. Four months later, Mr. McSherry found conditions to be no worse. While he concluded that the entire roof system should be replaced, and although he had not seen the 1977 engineering study that found that defective construction required replacement of the roof system, he opined that the problems with the roof system "absolutely" could not be attributed to construction defects.

An experimental repair to the roof in March 1993 resulted in some moisture problems that were permanently corrected shortly thereafter when the weather improved. The only tenant complaint of a leak occurred in June 1993. The leak was repaired and there was no evidence that it emanated from the roof. HUD has approved a December 1993 proposal to replace the roof and the specifications have been sent out for bid.

At Pemberton Manor, the combined effect of storm damage and defective construction necessitated repair and replacement of the roofs. By April 1993, Mr. Weitz and representatives of HUD's Baltimore and Philadelphia offices had appeared to reach an accomodation on the roofs. As an interim measure, in August 1993, new shingles were installed over the old ones. Mr. LaPierre, the HUD inspector, criticized the interim repairs. Although he has not reviewed the construction specifications, drawings, and change orders, Mr. LaPierre is also of the opinion that roof deficiencies cannot be attributed to construction defects. In April 1994 the mortgagee inspected Pemberton

Manor, finding the overall physical condition and the maintenance policies and practices to be "superior." Ms. Pelton, the Pemberton Manor property manager, confirmed that the interim repairs were well planned and accomplished, and that they have performed well. In January 1994, Mr. Weitz sent HUD a plan to replace the roofs and to repair the construction deficiencies at Pemberton Manor. Despite Mr. LaPierre's favorable review of the plan in May 1994, HUD has placed the plan in abeyance until the LDP and debarment proceedings are resolved.

Given the facts as summarized above, I find that "maintenance" of the roofs did not become an issue until HUD and Mr. Weitz reached an impasse over who would finance and ultimately pay for replacement of the roofs which, as early as 1977, were known both by HUD and Mr. Weitz to have been defectively constructed. The denouement occurred in early 1990 when Mr. Weitz closed voluntary "rainy day" accounts in response to HUD's rejection of applications for rent increases. Those increases would have covered debt service on loans for the replacement of the roofs.

There was absolutely no evidence of any health or safety concerns, or of any tenant complaints that related to the maintenance of the roofs at either project. There is ample evidence to demonstrate that, both before and after the liquidation of the "rainy day" accounts, Mr. Weitz has continuously taken interim maintenance measures to assure that the roofs have performed adequately, pending implementation of plans to fully replace the roofs at each project. The quality and extent of that maintenance, given the acknowledged need for a permanent solution to remedy construction defects, has not been shown to have been improper or unreasonable. A plan to replace the roof system at Essex House has been approved by HUD and the specifications have been sent out for bids. As noted above, plans for Pemberton Manor will not be cleared by the HUD Baltimore Office until the LDP and debarment proceedings are resolved. Accordingly, I conclude that there is no evidence upon which to conclude that cause for debarment exists under Count IV.

E. The Government Has Not Demonstrated that Respondents Improperly Distributed $223,965 in Essex House Project Funds While High Urgency Maintenance Items Were Outstanding

Count V alleges that Respondents improperly distributed $223,965[171] in Essex House project funds while high urgency maintenance items were outstanding. Paragraph 6 of the Regulatory Agreement prohibits a distribution if the project is not in "compliance with all outstanding *notices* of requirements for proper maintenance of the

[171]The $223,965 figure is comprised in part of the $212,033 note at issue in Count III, *supra*.

project." *See* Finding No. 173, *citing* AR-4B, ¶ 6(e)(4) (emphasis added). The Government argues that Respondents received the requisite notice upon receipt of a HUD physical inspection report in June 1989 that was issued in connection with Mr. Weitz' request for a rent increase at Essex House. That inspection report cited a "high urgency" need for maintenance on the "roofs, flashing, vents," the "drives, parking lots, paving, curbs," the "elevators," and the "fire extinguishers." Respondents argue that the inspection report did not suffice to invoke the Regulatory Agreement's prohibition against distributions for two reasons. First, they did not receive written notice of maintenance deficiencies sent by registered or certified mail and signed by the Federal Housing Commissioner as required by the Regulatory Agreement. Second, they did not receive any specific notice, directly or through any established policy or practice, that outstanding high urgency deficiencies noted on an inspection report precluded distributions until those deficiencies are cleared by HUD.

The Regulatory Agreement is ambiguous as to the form of notice required to preclude a distribution. Paragraph 11, the only other provision referring to "notice" in the Regulatory Agreement, refers to a "written notice. . .by registered or certified mail" that the Federal Housing Commissioner "may" give to an owner if any provision in the Regulatory Agreement has been violated. *See* Finding No. 174, *citing* AR-4B, ¶ 11. If the violation is not corrected, the Commissioner "may" then declare a default.[172] *Id*. Paragraphs 6 and 11 do not cross-reference each other. Moreover, by their express terms, they address different scenarios: Paragraph 6 pertains to notice of outstanding maintenance requirements and Paragraph 11 pertains to notice of Regulatory Agreement violations. Thus, while it is clear that "notice" for the purpose of Paragraph 11 must be in writing and sent by registered or certified mail, the same cannot be said of Paragraph 6.

[172]The Government argues that the notice provision in Paragraph 11 refers only to a declaration of default, and that because the notice provision is discretionary and has not been invoked in this case, it is irrelevant to the provision that prohibits a distribution when there is a *notice* of required maintenance. The argument is specious. Paragraph 11 contemplates progressive measures that may be taken to ensure compliance with *any* provision of the Regulatory Agreement. First the Commissioner may go forward with a notice of violation and an opportunity to correct the violation. Second, if the violation is not corrected after a period of time, he may proceed with a declaration of default. The Commissioner has discretion to proceed, but once having exercised that discretion, he is bound to give written notice by registered or certified mail. The type of notice to be given has nothing to do with the exercise of discretion to issue it.

The Regulatory Agreement's ambiguity is not clarified by any agency policy or practice. The Government cites no HUD Handbook, bulletin, issuance, or training curriculum stating that distributions are prohibited upon receipt of an inspection report noting "high urgency" maintenance deficiencies. Moreover, the letter from HUD along

with which the inspection report was forwarded directed Mr. Weitz to submit a property improvement plan to correct the high and medium urgency deficiencies, and did not state any consequence for failing to abide by its terms, including any reference to allowable distributions. Three HUD witnesses testified to the effect that there is no uniform practice within the agency as to how notice is given, what constitutes notice, or whether notice in an inspection report "automatically" prohibits distributions. Finally, there is no evidence that loan servicers uniformly require repayment of distributions if they discover inspection reports noting high urgency deficiencies while reviewing project financial statements.

In the absence of: 1) any formal notice in writing by the Commissioner; 2) any other specific notice that a distribution would be improper in light of the inspection report; or 3) any published rule, regulation, or practice that prohibits distributions in light of deficiencies noted in an inspection report, the Government has failed to show that Respondents made improper distributions of Essex House project funds and, therefore, that cause for debarment exists under Count V.

Conclusion and Determination

The evidence on all counts fails to demonstrate cause for Respondents' debarment, and therefore, that they are not presently responsible to continue to do business with the Government. This is not a case involving moral turpitude, nor is it one of a neglectful property owner. It is about a tough-minded businessman who dared challenge the federal Government's view of how best to operate and maintain multi-family housing projects. When Mr. Weitz disputed the conclusory findings of the audit and refused to pay what he claimed was not owed, a limited denial of participation -- and later, a suspension and this proposed debarment -- was held over his head like a sword of Damocles, a "tool" to exact compliance, not to encourage conciliation. In the main, this proceeding has turned into a dispute over ledger entries and financial activities that occurred up to twenty years ago, long after original source documents and workpapers are usually kept. It is a case based on an erroneous analytic foundation and fragmentary facts.

When the debarment and suspension action was initiated in Washington, D.C., the officials responsible for its initiation were unaware that Government counsel were ordered to respond to a motion alleging "intentional, flagrant, and continuous" violations of a discovery order issued in the LDP proceeding. At the same time, officials in the Regional Office, who had been attempting to resolve the audit findings until Government counsel requested cessation of those efforts, did not know that officials at headquarters were considering a suspension and proposed debarment. Given the substantive weakness of the case against Respondents, the circumscribed knowledge of that weakness afforded the debarring officials, and the time, effort, and money expended by all parties to this litigation, it is at least questionable whether the Government has exercised appropriate prosecutorial discretion in this case.

Accordingly, upon consideration of the entire record and the public interest, I conclude and determine that good cause does not exist to prohibit Benjamin B. Weitz and his named affiliate, Community Housing and Research Corporation, from participating in covered transactions as either participants or principals at HUD and throughout the Executive Branch of the federal Government and from participating in procurement contracts with HUD.

_____
ALAN W. HEIFETZ
Chief Adminisrative Law Judge

CERTIFICATE OF SERVICE

I hereby certify that copies of this INITIAL DECISION AND ORDER issued by ALAN W. HEIFETZ, Chief Administrative Law Judge, HUDALJ 94-0009-DB, were sent to the following parties on this 9th day of January, 1995, in the manner indicated:

_____
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